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ERRATA

Page 20, Table 4: Other Utilities 1963
Canada Controlled % "95" should read "96";
Other Controlled % "2" should read "—"

Page 25, Table 9: 1946-1967, last % column:
4th line "3" should read "33.8"
5th line should read "20.3"

Page 26, 3rd line "from" should read "by"

Page 59, 3rd line "side" should read "size"

Page 78, footnote 4: "Since the late 1970's" should read "Since 1970," and add after the sentence: "Furthermore, the pattern which had been established in 1969 was not reversed in 1971, even though temporarily reversed in the last half of 1970."

Page 88, footnote 13: 2nd last line: "outflows" should read "payments";
last line: "inflows" should read "receipts"

Page 101, 10th line from top: "bank;" should read "banks"
16th line from top: "syndicate." should read "syndicates."

Page 199, 6th line from top: "opposed" should read "approved"

Page 237, 10th line from bottom: "outflows" should read "payments"

Page 341, 18th line from top: "cost" should read "case"

Page 351, Table 53, heading: "PAID" should read "PAIT"
5th line from bottom "Conclusion" should read "Conclusions"

Page 368, 2nd line from top: "may be" should read "may not be"

Page 451, 3rd line from bottom: "mechanisms's" should read "mechanism's"

Page 504, 17th line from bottom: delete the words "ownership interest"

Page 509, 16th line from bottom: "point" should read "joint"

FOREIGN
DIRECT INVESTMENT
IN CANADA

FOREIGN DIRECT INVESTMENT IN CANADA

Published by the
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Foreword

In the spring of 1970, the Honourable Herb Gray, P.C., M.P., was given the responsibility of bringing forward proposals on foreign investment policy for the consideration of the government. To assist him in this task, a working group was later established by the government to prepare background material and to examine certain factors which should be taken into account in the government's consideration of this issue. This document, prepared by the working group, is being published to help public understanding and discussion of the matter.

The document, while being published under the authority of the Government of Canada, is not a statement of government policy nor should it be assumed that the government endorses all aspects of the analysis contained in it.

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Part One

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Chapter One

INTRODUCTION

THE PROBLEM OF FOREIGN DIRECT INVESTMENT IN CANADA

The degree of foreign ownership and control of economic activity is already substantially higher in Canada than in any other industrialized country and is continuing to increase.

Nearly sixty per cent of manufacturing in Canada is foreign controlled and in some manufacturing industries such as petroleum and rubber products foreign control exceeds ninety per cent. Sixty-five per cent of Canadian mining and smelting is controlled from abroad. Approximately eighty per cent of foreign control over Canadian manufacturing and natural resource industries rests in the United States.

In terms of total national wealth, the proportion controlled by non-residents may be of the order of ten per cent. But about one-third of total business activity in Canada is undertaken by foreign-controlled enterprises.

The bulk of this heavy foreign direct investment in Canada has occurred since the end of the last war, and it has unquestionably played an important role in the growth of the Canadian economy over the past quarter century. It has provided ready access to capital, entrepreneurship, managerial skills, new technology and, in many cases, to markets abroad. Foreign investment has resulted in enterprises being undertaken in Canada which would not otherwise exist. It has contributed in an important way to the growth of production, employment, incomes and government revenues in Canada.

Foreign investment has also brought with it a number of major problems, which have become a matter of increasing concern to many Canadians over the past decade and more.

Although steps have been taken in the past to deal with some of these issues, many problems remain unresolved and are likely to assume even larger proportions in the years ahead unless effective measures are adopted to deal with them.

The high and growing degree of foreign control of Canadian business activity can affect the balance between the manufacturing and resource sectors of the Canadian economy, and between the various sectors of manufacturing. The investment decisions of foreign-controlled corporations tend to reflect the laws and industrial priorities of foreign governments and economies

which, in turn, influence Canadian industrial priorities. These objectives and priorities of foreign corporations and governments do not appear to have conflicted in a significant way with Canadian economic goals in the past, but the anticipated high level of demand for resources by foreign economies could lead to undue emphasis on resource development in the coming decades. This, in turn, could impose major limitations on the ability of Canadians in future to formulate an industrial development policy geared to Canada's own particular growth and employment objectives.

The high level of foreign direct investment also affects the structure of Canada's manufacturing industry. Many foreign corporations invest in Canada to extend the market for their manufactured goods. They tend to produce a wide range of products in short runs to supply the Canadian market only. Furthermore, Canada can become locked into accepting a pattern of innovation and technological development which has its origins abroad. These tendencies add to the relatively high costs in the Canadian economy stemming from a variety of domestic factors and result in the establishment of dependent manufacturing operations which, in many cases, are not in a position to compete internationally.

The substantial degree of foreign investment in Canada has also carried with it other significant economic and social costs—some of them intangible and difficult to measure, some of them not even readily apparent. Direct investment by foreign companies has led to establishment in Canada of "truncated" enterprises, in which many important activities are performed abroad by the parent or other affiliated firms. Foreign controlled firms do not seek to perform certain tasks in Canada, with the result that Canadian skills and capacities are not developed adequately to support foreign *or* Canadian controlled enterprises. This reliance on external sources for many of the inputs of industrial activity has meant a lesser development of Canadian capacities—and perhaps even a stultification of these capacities.

Even the truncated foreign subsidiary frequently makes a contribution to the Canadian economy through the part it plays in increasing production and employment—both directly and indirectly. The truncated form of operation may make economic sense and represent an efficient form of international specialization. Indeed, the degree of truncation may, in part, reflect the underlying costs of production in Canada and the truncated subsidiary may have achieved as efficient a form of production as could be expected, given Canada's relative cost structure. The degree of truncation, however, may also reflect a number of external factors, as indicated below. But the essential point—and one that is central to an understanding of this study—is that truncated subsidiary operations usually lack the capacity and opportunity over time to develop the full range of activities normally associated with a mature business enterprise.

Foreign direct investment has by no means been the sole cause of Canada's shortcomings in developing an efficient, productive, well balanced and innovative economy that is capable of meeting international competition

on equal terms both at home and abroad. Nor would a reduction in foreign direct investment resolve these problems because the economy would continue to be strongly influenced by external forces.

Past Canadian tax, tariff, competition and other economic policies have contributed to the creation or perpetuation of weaknesses evident in the economy and the resulting high costs in a number of industries, even though these policies might have been justified in terms of other objectives or circumstances existing at the time of their adoption. These high costs inhibit the sound and healthy growth not only of Canadian owned companies, but also of foreign owned companies, and reduce the potential benefits from foreign direct investment. It must be emphasized, however, that these general policies serve a number of other government objectives, so that they cannot necessarily be drastically reframed to achieve the objectives associated with foreign direct investment.

In addition to these domestic factors, however, the potential for broad development of the Canadian economy has also been limited by a number of external factors. These include the imperfections in world markets resulting from the existence of international oligopolies, the policies of foreign governments which work against Canadian interests, the possible distortions and biases of that postwar phenomenon, the multinational enterprise (MNE), and the committed investment costs of foreign parent companies in other locations.

If foreign direct investment merely created problems, it would be a simple matter to deal with it; all foreign investments could simply be blocked. But in many cases foreign investment is a complex mix of costs and benefits, both of which are extremely difficult to quantify in economic terms—to say nothing of social, cultural and political terms—for the nation as a whole. Since foreign investment will likely continue to be an important factor in Canada for many years to come, Canadians must explore alternative means of reducing the cost of foreign investment and increasing to the greatest extent possible the benefits which it can bring to the nation over the long term.

These would include general economic policies aimed at increasing the efficiency of the Canadian economy as a whole by reducing the level of costs and also more specific measures to reduce certain gaps in Canadian capacities and stimulate the development of vigorous, efficient, well-managed and innovative Canadian owned companies that are fully capable of meeting foreign competition at home and abroad.

But they would also include policies aimed more directly at increasing the benefits to be derived from foreign direct investment by reducing or overcoming the limitations that stem, not from economic factors originating in Canada, but from factors that reflect the nature of the international market place and of international corporations. The importance of moving in this direction is underlined by the increasing internationalization of some important sectors of industry, and the growth of the multinational enterprise as

an institutional development of foreign direct investment. Many United States companies, for example, built their first foreign branches in Canada but now have branches in many countries. The existence of production facilities in various countries increases the power and flexibility of the multinational enterprise (MNE) in its dealings with the Canadian government. It also intensifies the problems of truncation by reducing the likelihood of the MNE moving more activities to Canada, particularly since other governments actively intervene to control non-resident owned corporations in their jurisdiction. The bargains other governments strike with an MNE may have an adverse impact on Canada, particularly if Canada lacks similar bargaining levers or does not choose to use them. In pursuit of its own economic objectives, it is necessary for Canada to develop policies and techniques which take full account of the nature and structure of the multinational enterprise, turning them to the maximum advantage possible for the Canadian economy.

In examining the impact of foreign direct investment on Canada's political, economic and social development, three key issues emerge. The first relates to the kind of economy and environment in which Canadians want to live and work. Can the Canadian people and their governments develop the sort of stimulating and innovative environment that will result in a less truncated and less marginal economy? Can they develop the kind of economy that will help to keep creative Canadians in Canada and to reduce the present heavy reliance on the ideas and technology of others? The second is whether our economic structures, institutions, and policies provide the necessary tools for Canada to control and direct its national priorities. The third is the distribution of the costs and benefits from foreign direct investment between Canada, the foreign investor, and the foreign investor's own economy.

The discussion which follows addresses itself to these questions. It suggests that there is a pressing need for the Canadian government and the Canadian people to take stock of the present situation, particularly in view of rapidly changing circumstances at home and abroad, and to consider measures that will permit Canada to exercise greater control over the domestic environment, to obtain a larger share of the benefits from foreign direct investment, and to achieve greater Canadian participation in the economic life of the nation—measures that will at the same time help to promote even stronger growth of the Canadian economy. Measures designed to achieve these ends should make some contribution as well to the development of a more stimulating and innovative Canadian society.

OBJECTIVES OF THE STUDY

The objectives of this study are:

(i) To analyse the impact of the high degree of foreign control of Canadian business over Canadian development and the implications this has for the capacity of Canadians to control the national

economic environment; that is, to make and implement decisions for the welfare and benefit of the 22 million Canadians living within our borders. This involves consideration of the extent to which domestic economic policies and the domestic environment have contributed to present problems.

(ii) To canvass the range of policy options that might enable Canadians:

(a) to exercise greater control over the national economic environment;

(b) to maximize the benefits and minimize the costs to Canada of foreign direct investment; and

(c) to retain and increase Canadian ownership of business activity where this is feasible or desirable for economic, social, cultural, or other reasons.

Greater domestic control, maximum net benefits from foreign investment, and Canadian ownership of business activity are not being sought for their own sake, but to help achieve Canada's basic aims as identified in the government's recent review of foreign policy:

—foster economic growth;

—safeguard sovereignty and independence;

—work for peace and security;

—promote social justice;

—enhance the quality of life;

—ensure a harmonious natural environment.

This study is intended to explore a number of measures in relation to foreign investment that might contribute to the achievement of these objectives. The policy options put forward for consideration are also designed to take account of a number of other important government objectives. In particular, careful attention has been given to the need for:

(i) economic growth and employment, including regional economic development;

(ii) good federal-provincial relations;

(iii) the maintenance of access for Canada to the best available technology and other inputs; and

(iv) industrial efficiency.

FOCUS OF THE STUDY

In examining the problems associated with foreign direct investment, it became apparent that the achievement of the Canadian objectives ultimately requires an efficient and dynamic economy to attract and hold the necessary

business and industrial activity. Such an environment would make it economically practical for all companies, including those that are foreign controlled, to locate more activity in Canada—for example, by undertaking more production of components, more goods for export or more research and development—and would strengthen the government's hand in pressing them to do so.

The general competitiveness and efficiency of the Canadian economy—including both the foreign and Canadian controlled sectors—is in the long run determined by the framework of general economic policies, which the government is constantly seeking to improve. In addition, policies aimed at remedying specific deficiencies in the economy would also improve the potential contribution of foreign direct investment and support Canadian controlled enterprise. Improved Canadian capital markets, managerial skills, and technological capacity, for example, would all contribute to the achievement of these aims. Policies specifically designed to foster the development of Canadian owned enterprise might also help to offset some of the particular disadvantages which they now face.

While much could be accomplished by action on both these fronts, it also became apparent from the analysis that a number of residual problems would remain unresolved because of distortions in the international marketplace, the policies of other governments and the nature and structure of large international companies. It was concluded that consideration should be given to taking further steps aimed at dealing in a more specific way with the problems of foreign investment. Three alternatives have been put forward. These involve:

(i) the introduction of a foreign direct investment review process through which a government agency would be empowered to negotiate for better performance from certain categories of foreign direct investors (for example, further processing), and with the authority to block investment that does not make a net contribution to the Canadian economy or that does not accord with the objectives of the government;

(ii) the delineation of further key sectors in which foreign ownership would be regulated; and

(iii) the introduction of across-the-board ownership rules, such as 51 per cent Canadian ownership and other changes relating to the use of Canadian managers and directors.

At various points in the study, these three alternatives are mentioned and their effectiveness in dealing with the problems under discussion is considered. Particular attention has been given to defining a role for a review process, which emerged from the analysis as one of the most effective ways of dealing with a number of the problems that arise out of the substantial degree of foreign investment in Canada.

It should be pointed out that each of the three broad approaches outlined above—improvements in general economic policies, the introduction of

specific measures aimed at remedying gaps in the economic system, and limited administrative intervention to deal with residual aspects of foreign direct investment—would complement and reinforce each other. Increasing efficiency and lowering costs would make possible better economic performance by both Canadian and foreign owned companies. Such a development would, in turn, put the government in a better position to foster the growth of Canadian owned enterprise through specific remedial measures and to press foreign owned companies to reduce the costs and increase the benefits to the economy of their operations in Canada.

Chapter Two

THE GROWTH OF FOREIGN INVESTMENT IN CANADA

HISTORICAL DEVELOPMENTS

External capital has always played an important role in Canada's history. In the earlier years, non-residents supplied much of the money needed to build our railways, canals, roads and other public utilities. They were also instrumental in the development of new mineral deposits, some manufacturing industries, new sources of power, as well as being an important source of government finance.

Prior to World War I, external capital constituted a higher proportion of capital employed in the economy than at any time since. In relative terms, therefore, this was the time when foreign investment made its greatest contribution to the economy.

Despite this heavy reliance on external capital, foreign control of Canadian business (apart from railways) was not great in the half-century following Confederation because much of it came in the form of debt securities, rather than equity. During that period, the London bond market was the main source of Canada's foreign capital. There was some direct investment from abroad, but it appears to have constituted no more than a third of total foreign investment.

The situation changed after the outbreak of World War I. The United States replaced the United Kingdom as Canada's major supplier of external capital. Since then the United Kingdom has played a relatively minor role in supplying Canada's capital investment needs.

Between 1914 and 1930, United States direct and portfolio investment in Canada grew rapidly. For reasons outlined in the following chapters, United States investors showed a greater interest in direct investment than those in the United Kingdom. The United States investors also tended to concentrate in particular sectors, including the extractive and processing industries, automobile manufacturing, pulp and paper production, non-ferrous metal mining and refining, and the manufacture of electrical apparatus and supplies. At the same time, Canadian governments, municipalities, utilities and private companies turned increasingly to the New York money markets for their borrowings. By 1930, United States capital investment in Canada was roughly

57 per cent in portfolio (principally debt) and 43 per cent in direct investment (principally equity).

The decade of the thirties was a period of relatively low investment activity in Canada and both United Kingdom and United States investment declined, both through the repatriation of Canadian securities owned abroad and withdrawals of capital placed in direct investments by non-residents.

Very large capital expenditures were, of course, made during World War II, mainly connected with the war effort, e.g., to expand or establish industries producing aluminum, nickel, other metals, chemicals, electronic products, aircraft and ships. These were largely financed from Canadian sources. British investments declined by about $750 million during that period, offset by a growth in United States investment of a similar amount, of which about half was direct investment.

Between 1945 and 1967, the book value of United States long-term investment in Canada rose from just under $5 billion to $28 billion, with the direct investment portion increasing from around $2 billion to $17 billion. About half the increase in United States direct investment during this period was for the development of Canada's natural resources. A large proportion of the investment in resource exploitation reflected the needs of the United States investors for raw materials for their processing and manufacturing plants in the United States. These captive export markets were a particularly important factor in a number of developments, as the very heavy capital costs involved were apparently very difficult to justify without assured markets for the output, such as was the case for the Quebec-Labrador iron ore fields and newsprint, and sufficiently large markets were not then available in Canada. This so-called "backward vertical integration"—the integration of the earlier stages of the productive process—by United States processors and manufacturers had the practical impact, in some cases, of reducing the likelihood of further processing activity of Canadian natural resources in Canada.

The remainder of the direct investment from the United States was largely in manufacturing, for the starting up of new enterprises, the expansion of existing plants and the takeover of Canadian firms.

As for the growth in portfolio investment of about $8 billion, about half was in government bonds, with the remainder divided largely between Canadian stocks and corporate bonds, payments in respect of the Columbia River Treaty, mortgages, real estate and other miscellaneous items.

Table 1 below shows some of the changes and trends in foreign investment in Canada over the past seventy years. It illustrates the swing towards direct investment and the growth in the relative importance of United States investments. Direct investment comprised sixty per cent of total foreign capital invested by the end of 1967, compared with thirty per cent in 1926. United States investment accounted for 81 per cent of total foreign capital invested in Canada in 1967, whereas it was only 53 per cent in 1926.

Table 1

ESTIMATED BOOK VALUE OF FOREIGN CAPITAL INVESTED IN CANADA, SELECTED YEAR-ENDS, 1900 TO 1967*

(All dollar figures are in Millions)

	1900		1914		1930		1939		1946		1950		1960		1967	
	$	%	$	%	$	%	$	%	$	%	$	%	$	%	$	%
Owned by residents of:																
The United States																
Direct	—		—		1,993	26.1	1,881	27.2	2,428	33.8	3,426	39.5	10,549	47.4	17,000	48.9
Portfolio and Other	—		—		2,667	35.0	2,270	32.8	2,730	38.0	3,123	36.0	6,169	27.7	11,030	31.7
Totals	168	13.6	881	23.0	4,660	61.2	4,151	60.0	5,158	71.8	6,549	75.5	16,718	75.2	28,030	80.7
Britain																
Direct	—		—		392	5.1	366	5.2	335	4.6	468	5.4	1,535	6.9	2,152	6.2
Portfolio and Other	—		—		2,374	31.1	2,110	30.5	1,335	18.5	1,282	14.7	1,824	8.2	1,424	4.1
Totals	1,050	85.2	2,778	72.4	2,766	36.3	2,476	35.8	1,670	23.2	1,750	20.1	3,359	15.1	3,576	10.3
Other Foreign Countries																
Direct	—		—		42	.5	49	.7	63	.8	81	.9	788	3.5	1,547	4.4
Portfolio and Other	—		—		146	1.9	237	3.4	290	4.0	284	3.2	1,349	6.0	1,549	4.4
Totals	14	1.1	177	4.6	188	2.4	286	4.1	353	4.9	365	4.2	2,137	9.6	3,096	8.9
All Foreign Countries																
Direct	—		—		2,427	31.8	2,296	33.2	2,826	39.3	3,975	45.8	12,873	57.9	20,699	59.6
Portfolio and Other	—		—		5,187	68.1	4,617	66.7	4,355	60.6	4,689	54.1	9,342	42.0	14,003	40.3
Totals	1,232		3,837		7,614		6,913		7,181		8,664		22,214		34,702	

*Source: DBS Estimates for 1900 and 1914 by Viner and Knox.

RECENT TRENDS AND THE CURRENT EXTENT OF FOREIGN CONTROL OF CANADIAN BUSINESS ACTIVITY

Two sets of Canadian statistics are available regarding the current extent of foreign ownership and control of Canadian business. These are the International Investment Position data collected by the Balance of Payments Section of Statistics Canada and the *Corporations and Labour Unions Returns Act* (CALURA) data, also compiled by Statistics Canada. While these two sets of statistics differ in concept, coverage and yardstick employed, both contribute to an appreciation of the extent of the ownership and control of domestic industries by non-residents.

The Investment Position statistics compiled on foreign ownership and control go back to 1926. The most recent figures are for 1967. The CALURA data only go back until 1962 and the most recent statistics are for the year 1968.

Table 2 shows the growth in the degree of foreign ownership and foreign control since 1954 in selected industries. These aggregate data include most of the non-agricultural industrial economy except the financial industry and illustrate the degree of growth in both foreign ownership and foreign control experienced between the mid-1950's and 1967. They also suggest a more rapid growth in foreign control than in foreign ownership. Table 2 also indicates that United States controlled firms account for 80 per cent of foreign control.

TABLE 2*

ESTIMATED BOOK VALUE†, OWNERSHIP AND CONTROL OF CAPITAL EMPLOYED IN SELECTED‡ CANADIAN INDUSTRIES YEAR ENDS, 1954–67

Year	Total Capital Employed	CANADA				U.S.				OTHER			
		Owned		Controlled		Owned		Controlled		Owned		Controlled	
	($ billions)	$	%	$	%	$	%	$	%	$	%	$	%
1954	28.2	19.0	68	20.2	72	7.1	25	6.9	24	2.1	7	1.1	4
1960	45.6	29.9	66	30.4	67	12.1	27	12.0	26	3.6	7	3.2	7
1963	51.8	33.5	65	34.1	66	14.6	28	14.1	27	3.7	7	3.6	7
1964	55.3	35.8	65	36.4	66	15.8	28	15.0	27	3.8	7	4.0	7
1965	60.0	38.8	65	39.5	66	17.2	29	16.2	27	4.0	6	4.4	7
1966	65.7	42.3	64	43.1	66	19.3	29	18.0	27	4.2	7	4.7	7
1967	71.6	46.4	65	46.8	65	20.9	29	19.9	28	4.4	6	5.0	7

*SOURCE: DBS.

†The book value of long-term debt and equity (including retained earnings) employed in enterprises in Canada expressed in billions of dollars.

‡Selected industries include manufacturing, petroleum and natural gas, mining and smelting, railways, other utilities and merchandising and construction.

Two factors probably tend to reduce the scope for further sharp increases in foreign control: the degree of foreign control of Canadian business in the economy is already very high; secondly, of the capital employed by Canadian controlled firms, about one-third is in government enterprises.

Nevertheless, it is noteworthy that the 1967 (the most recent year) data showed a further small increase over 1966.

Moreover, a recent unpublished Statistics Canada analysis, based on Investment Position data, suggests the possibility that further increases in foreign control may have been experienced in 1968 and 1969. The analysis revealed that gross savings and net savings of foreign controlled firms, as a percentage of total gross and net savings for the selected industries covered in Table 2, increased sharply between 1965 and 1969. In 1968-69, 42 per cent of both gross and net savings in these selected industries were generated by the foreign controlled firms, even though they employed only 35 per cent of the capital. This apparently did not reflect a substantial improvement in total earnings of foreign controlled firms as compared to Canadian controlled firms. It was instead a consequence of a very sharp reduction in dividends remitted by foreign controlled firms to parents, particularly by the automotive firms, in order that they might maintain their Canadian capital investment programmes. This suggests that when the 1968 and 1969 Investment Position data become available, they may show a further small increase in foreign control.

RECENT TRENDS AND THE CURRENT EXTENT OF FOREIGN CONTROL OF CANADIAN BUSINESS ACTIVITY: CALURA DATA

Table 3 below shows the importance of non-resident ownership in the economy, except the financial industry. It indicates that in 1968 non-resident owned firms owned 34.2 per cent of all Canadian corporate assets[1] in the

TABLE 3*

CORPORATIONS 50% OR MORE NON-RESIDENT OWNED
TOTAL NON-FINANCIAL INDUSTRIES

	Assets		Equity		Sales		Profits		Taxable Income	
Year	$ Million	%	$ Million	%	$ Million	%	$ Million	%	$ Million	%
1965	27,973	36.0	15,076	40.0	29,478	34.6	2,522	46.0	1,694	48.6
1966	31,794	37.4	16,414	40.7	33,307	35.1	2,660	44.1	1,624	46.4
1967	35,244	38.0	17,973	41.5	35,958	35.0	2,618	43.8	1,561	44.6
1968†	39,675	39.6	19,948	43.2	40,623	36.6	3,195	47.4	1,974	47.1
1968‡	39,923	34.2	20,051	40.3	40,744	35.1	3,216	43.8	2,001	47.7

* SOURCE: CALURA.
† Before inclusion of exempt corporations.
‡ After inclusion of exempt corporations reporting under federal legislation other than CALURA and of government enterprises which operate in the non-financial industries.

[1] A certain proportion of the assets of the non-financial firms which are non-resident owned represents investments in and claims against affiliated firms. These affiliates report separately to CALURA. Hence there is some double counting of assets.

non-financial industries and 40.3 per cent of corporate equity, made 35.1 per cent of corporate sales, earned 43.8 per cent of corporate profits and 47.7 per cent of taxable income.

CALURA also publishes figures on non-resident ownership for all industries, including the financial industry. Owing to statistical problems, these data are a less reliable guide to non-resident ownership than those cited above. This latter source, however, is the base for the often publicized $50 billion needed for "buying back" Canada. This figure, or more precisely the figure of $50.8 billion in the 1968 CALURA report, does not represent the book value of foreign direct investment in Canada, owing in part to the fact that this figure contains extensive double counting. The value of assets of non-financial firms in 1968, after all double counting has been removed, is estimated at $33.1 billion.

Even this figure does not represent the book value of foreign direct investment in Canada. Many non-resident owned firms have minority Canadian shareholders. The assets of others include debts owed to Canadians. In short, any figure which one might select as representing the book value of foreign direct investment in Canada would require a precise indication of what was included and excluded by this expression. An estimate somewhat below $30 billion (in 1968) might be a fair indication of the order of magnitude in that year. Such an amount, incidentally, is not unlike the figure on foreign ownership of capital employed in the Investment Position data in Table 2, if one extrapolates the trend in that table through to 1968.

But even this does not tell what the cost of any "buy back" policy would be as it reflects book value, not market value. No estimates have been done on the market value of foreign direct investment in Canada. For example, a major consideration influencing the market value is whether the initiative for the purchase of the controlling shares of a firm rests with the buyer or the seller. If all foreign investors in Canada became concerned about the Canadian economic or political environment and decided to get out, the pressure to sell would be such that many would have to settle for much less than book value. On the other hand, if Canadian entrepreneurs were to decide that they wanted to acquire a large number of foreign controlled firms, they might well find themselves obliged to pay substantially more than the book value, or even current market value, to get controlling interest in some of these firms.

In summary, a figure a little below $30 billion (in 1968) is a reasonable estimate of the book value of foreign controlled firms. No estimate is available on current market value and even if one were it would not necessarily be a good indicator of the cost of "buy back".

FOREIGN CONTROL: SECTORAL BREAKDOWN

Both the International Investment Position data and the CALURA data provide further information by sector on the degree of non-resident participation in the Canadian economy.

Details from the International Investment Position data are set out in Table 4. It shows that the areas of greatest concentration of direct foreign investment are in manufacturing and natural resources. Non-resident control in manufacturing is estimated at 57 per cent at the end of 1967, with $11.8 billion of the $20.5 billion total capital employed controlled by non-residents. Residents of the United States controlled $9.4 billion (or eighty per cent of the capital employed which was controlled by all non-residents).

Of the $9.7 billion capital employed in the petroleum and natural gas industry at the end of 1967, again using Investment Position data, $7.2 billion, or 74 per cent, was controlled by non-residents. United States residents controlled $5.8 billion (or 81 per cent of the capital employed which was controlled by all non-residents).

In mining and smelting, total capital employed was $5.2 billion, of which $3.4 billion (65 per cent) was controlled by non-residents. Residents of the United States controlled $2.9 billion (or 85 per cent of the capital employed which was controlled by all non-residents). In all three instances the degree of foreign control exceeded the degree of foreign ownership.

The Investment Position data show trends by industry grouping since the early 1950's. They reveal that between 1954 and 1967 foreign control grew in manufacturing, oil and gas and mining, but declined in utilities and railways.

Table 5, based on the 1968 CALURA report, provides figures on the percentage of non-resident ownership in various industries as measured by assets, sales, profits and taxable income.

Within the manufacturing industries, non-resident ownership is greatest in the petroleum and coal products industry. The others in which there is very great non-resident ownership include: rubber products, transport equipment, tobacco and chemicals. In each case four-fifths or more of the assets, sales, profits and taxable income are accounted for by non-resident ownership. Other industries in which non-resident ownership exceeded one half of industry assets include machinery, electrical products, and primary metals.

In contrast, the industries in which Canadian ownership is greatest include: furniture, printing and publishing,[2] leather products, wood, food and beverages, textiles and clothing, and non-metallic mineral products.

Taking manufacturing industries as a whole, non-resident owned firms accounted for a higher proportion of profits and taxable income than for sales; and in fourteen of the eighteen manufacturing industries shown, the profitability of non-resident owned firms in relation to sales was greater than for resident owned firms. While the absolute data are not sufficiently

[2] The value and size of the printing industry is greater than the value and size of the publishing industry. This helps explain why the "Printing and Publishing Industry" can be largely Canadian owned, in spite of the high degree of foreign control of Canadian publishing houses.

TABLE 4*

ESTIMATED BOOK VALUE**, OWNERSHIP AND CONTROL OF CAPITAL EMPLOYED IN SELECTED CANADIAN INDUSTRIES, YEAR ENDS, 1954–1967

Year	Total Capital Employed	Canada				U.S.				Other			
		Owned		Controlled		Owned		Controlled		Owned		Controlled	
	($ billions)	$	%	$	%	$	%	$	%	$	%	$	%
Manufacturing													
1954	8.3	4.4	53	4.1	49	3.1	37	3.4	41	0.8	10	0.8	10
1960	12.2	5.8	48	5.1	41	5.1	41	5.4	44	1.4	11	1.8	15
1963	13.7	6.2	46	5.5	40	6.0	44	6.3	46	1.4	10	1.9	14
1964	14.8	6.8	46	5.9	40	6.5	44	6.8	46	1.5	10	2.1	14
1965	16.7	7.8	47	6.9	41	7.3	44	7.7	46	1.5	9	2.1	13
1966	18.7	8.8	47	7.9	43	8.3	44	8.5	45	1.6	9	2.2	12
1967	20.5	9.9	48	8.8	43	9.0	44	9.4	45	1.6	8	2.4	12
Petroleum/Natural Gas													
1954	2.5	1.0	40	0.8	31	1.4	57	1.7	67	0.1	3	0.1	2
1960	6.1	2.3	38	1.6	27	3.2†	53	3.9†	64	0.5†	9	0.6†	9
1963	7.6	2.8	37	2.1	28	4.0	53	4.6	61	0.8	10	0.9	11
1964	7.9	3.0	38	2.2	28	4.0	51	4.7	60	0.8	11	1.0	12
1965	8.3	3.1	37	2.2	27	4.2	51	4.8	58	1.0	12	1.3	15
1966	9.1	3.3	37	2.3	26	4.7	51	5.4	59	1.1	12	1.4	15
1967	9.7	3.7	38	2.5	26	4.9	51	5.8	60	1.1	11	1.4	14
Mining/Smelting													
1954	1.9	0.8	44	0.9	49	0.9	48	0.9	49	0.2	8	—	2
1960	3.3	1.3	40	1.3	39	1.7	52	1.7	53	0.3	8	0.3	8
1963	3.8	1.5	39	1.6	41	2.0	53	2.0	52	0.3	8	0.3	7
1964	4.1	1.7	40	1.7	41	2.1	51	2.1	51	0.4	9	0.3	8
1965	4.4	1.8	41	1.7	40	2.2	51	2.3	52	0.4	8	0.3	8
1966	4.8	2.0	41	1.8	38	2.5	51	2.6	53	0.4	8	0.4	9
1967	5.2	2.0	39	1.8	35	2.7	51	2.9	56	0.5	10	0.5	9
Railways													
1954	4.1	2.7	66	4.0	98	0.6	15	0.1	2	0.8	19	—	—
1960	5.3	3.9	74	5.2	98	0.5	9	0.1	2	0.9	17	—	—
1963	5.3	4.1	78	5.2	98	0.5	9	0.1	2	0.7	13	—	—
1964	5.3	4.2	79	5.2	98	0.4	8	0.1	2	0.7	13	—	—
1965	5.3	4.2	80	5.2	98	0.4	8	0.1	2	0.6	12	—	—
1966	5.4	4.3	80	5.3	98	0.4	8	0.1	2	0.6	12	—	—
1967	5.5	4.5	81	5.4	98	0.4	8	0.1	2	0.6	11	—	—
Other Utilities‡													
1954	5.3	4.6	86	4.9	92	0.6	12	0.4	7	0.1	2	—	1
1960	9.2	7.9	86	8.7	95	1.1	12	0.4	4	0.2	2	0.1	1
1963	11.3	9.8	86	10.8	95	1.4	13	0.4	4	0.1	1	0.1	2
1964	12.3	10.2	83	11.8	96	2.0	16	0.5	4	0.1	1	—	—
1965	13.4	11.1	83	12.8	96	2.2	16	0.5	4	0.1	1	—	—
1966	14.9	12.2	82	14.2	96	2.5	17	0.6	4	0.1	1	—	—
1967	16.2	13.2	81	15.5	95	2.9	18	0.7	5	0.1	1	0.1	—

*SOURCE: DBS.

**The book value of long-term debt and equity (including retained earnings) employed in enterprises in Canada expressed in billions of dollars.

†New series.

‡Utilities include air, road, water and urban transport, telecommunications, and hydro-electric utilities and many of the large Crown Corporations.

accurate to enable us to put forward precise figures on the comparative profitability of Canadian and non-resident owned firms, the generally higher profitability of non-resident owned firms does tend to lend strength to the earlier analysis regarding the ability of the foreign controlled firm to exploit its distinctive advantages in Canada.

Finally, it is also evident from the data that the high technology industries are generally non-resident dominated.

TABLE 5*

Manufacturing Industry	Percentage Majority of Non-Resident Ownership† as Measured by			
	Assets	Sales	Profits	Taxable Income
Food and beverages	31.2	27.2	30.1	32.5
Tobacco	84.3	79.9	82.7	83.3
Rubber products	93.1	91.4	90.0	88.4
Leather products	22.0	21.4	25.2	27.3
Textile industries	39.4	28.5	54.4	54.3
Wood	30.7	22.0	23.6	22.9
Furniture	18.9	15.6	20.8	23.2
Printing, publishing and allied	21.0	13.8	22.3	23.2
Paper and allied products	39.4	41.4	40.6	40.2
Primary metals	55.3	51.1	62.4	64.3
Metal fabricating	46.9	45.2	65.0	63.1
Machinery	71.8	72.6	78.9	88.3
Transport equipment	86.6	90.5	89.9	88.5
Electrical products	64.2	62.8	78.2	88.0
Non-metallic mineral products	51.5	42.3	47.0	53.1
Petroleum and coal products	99.5	98.9	98.6	99.4
Chemicals and chemical products	81.5	81.3	89.6	89.4
Miscellaneous manufacturing	53.9	51.2	72.1	72.6
Total—All Manufacturing	58.0	54.7	63.6	62.9

*SOURCE: CALURA, Annual Report 1968.

†The figures for all the industries in Tables 5 and 6 include information from corporations, except for financial industries, which are exempt from the provisions of CALURA, but which report to the federal government under other federal legislation; it also includes information from government enterprises. The figures for the financial industries may be less reliable owing both to some double counting among reporting firms and the absence of any data from others.

In mining, again according to CALURA, almost 63 per cent of assets, 60 per cent of sales, 55 per cent of profits and 47 per cent of taxable income are accounted for by non-resident owned firms. Thus, in terms of assets and sales, non-resident participation is greater in mining than in manufacturing.

On the other hand, large parts of the remainder of the economy remain predominantly Canadian owned.

TABLE 6*

Industry	Percentage of Majority Non-Resident Ownership as Measured by			
	Assets	Sales	Profits	Taxable Income
Construction	14.5	11.3	13.4	17.9
Transportation	8.9	11.3	26.5	25.6
Communications	1.0	1.1	0.5	1.1
Public Utilities	2.7	8.0	8.1	28.6
Wholesale trade	27.9	27.4	30.1	30.6
Retail trade	20.5	18.6	17.8	32.8
Financial industries	12.8	11.7	19.2	14.6

*See footnotes under Table 5.

REGIONAL DISTRIBUTION OF FOREIGN CONTROLLED FIRMS

It should be noted, with respect to Table 6, that several of the industries are ones in which there is a large public investment (such as power, gas, water and transportation) or restrictions ~~on~~ foreign investment (financial institutions) or both public investment and restrictions (communications). It should also be noted that the figures in Table 6 probably overstate the degree of non-resident ownership, as a significant amount of the investment capital in some of these industries is in unincorporated businesses which do not report to CALURA.

Data contained in the 1968 CALURA report, based upon statistics on taxable income, provide some indication of the regional distribution of foreign owned firms. While taxable income is only one of several possible indicators of regional distribution, it is probably as good as any other single one which might be chosen.[3]

As might be expected, Ontario and Quebec, as the two most important centres of industrial activity were, for the most part, also the most important centres of foreign ownership. In the case of Ontario, this also reflected the fact that foreign ownership in that province was higher than the national rate in the manufacturing and mining sectors and either close to, or above average in most other sectors. Foreign ownership in Quebec was somewhat

[3] The limitations of taxable income as a criterion for measuring the regional distribution of foreign ownership are set out on pages 35 to 37 of the Report for 1968, Corporations and Labour Unions Returns Act, Part I.

below national levels in all sectors except services and utilities. Table 7 below shows the relative importance of foreign owned firms to each region by industrial sector using the criterion of taxable income.

TABLE 7

PERCENTAGE OF CORPORATIONS TAXABLE INCOME EARNED IN EACH INDUSTRIAL SECTOR* AND REGION ATTRIBUTABLE TO NON-RESIDENT-OWNED COMPANIES, 1965–1968 AVERAGE

Industrial Sectors	Atlantic Provinces	Quebec	Ontario	Prairies	B.C.	CANADA
Agriculture, forestry, fishing and trapping	50.0	—	14.3	9.1	25.2	21.1
Mining	88.9	40.6	59.2	76.4	26.5	55.0
Manufacturing	59.6	60.3	70.1	60.5	44.1	63.8
Construction	10.2	12.1	19.0	23.1	42.6	20.6
Transportation, storage, communications and public utilities	23.9	34.8	15.2	17.5	11.0	19.7
Wholesale trade	17.4	32.2	39.7	38.4	30.8	35.7
Retail trade	30.3	27.1	36.2	52.2	40.5	37.3
Finance	21.8	22.3	25.6	28.3	26.6	30.6
Services	24.4	41.9	39.1	40.6	27.8	38.7

*SOURCE: CALURA.

Foreign ownership of the manufacturing industries as measured by taxable income averaged almost 64 per cent over the four-year period under review. In only one region, British Columbia, did Canadian owned companies earn a greater proportion of taxable income than foreign owned ones. Non-resident ownership in manufacturing was highest in Ontario at 70 per cent, followed by the Prairies (61 per cent), Quebec and the Atlantic provinces (60 per cent) and British Columbia (44 per cent).

In manufacturing, CALURA also provides similar regional details for 21 specific industries. These illustrate that the concentration of foreign owned manufacturing activity in Ontario reflects both the fact that Ontario is Canada's manufacturing centre and that foreign investors are investing relatively more in Ontario than in other regions, as compared to domestic investors.

Table 8 below shows the regional distribution of foreign-owned firms by industrial sector, again using the criterion of taxable income.

Ontario was the most important centre of foreign owned manufacturing activity. Some 58 per cent of the taxable income accruing to foreign owned corporations in this industry was earned in Ontario. This was about two and a half times the proportion earned in Quebec, the next most important province in this respect, and once again reflects both the pre-eminence of Ontario as Canada's principal centre of manufacturing and the fact that it has

attracted a proportionately larger share of foreign manufacturing investment than of Canadian manufacturing investment, even though the latter is high in comparison to other provinces.

TABLE 8

PERCENTAGE OF TAXABLE INCOME OF FOREIGN OWNED* CORPORATIONS ATTRIBUTABLE TO EACH GEOGRAPHICAL REGION BY INDUSTRIAL SECTORS, 1965–1968 AVERAGE

Industrial Sectors	Atlantic Provinces	Quebec	Ontario	Prairies	B.C.	CANADA
Agriculture, forestry, fishing and trapping	8.5	—	12.8	6.4	72.3	100.0
Mining	8.1	24.9	21.2	38.2	7.6	100.0
Manufacturing	2.7	23.7	58.2	8.7	6.7	100.0
Construction	3.9	12.0	35.5	22.3	26.3	100.0
Transportation, storage, communications and public utilities	12.4	31.9	21.9	26.5	7.3	100.0
Wholesale trade	2.6	22.5	48.6	16.9	9.4	100.0
Retail trade	6.9	15.8	37.5	25.5	14.3	100.0
Finance	4.4	23.4	45.0	17.8	9.4	100.0
Services	1.9	30.5	39.3	15.3	13.0	100.0

*SOURCE: CALURA.

Most foreign owned taxable income from mining (including oil and gas) was derived from the Prairies, Quebec, and Ontario, which accounted respectively for 38 per cent, 25 per cent and 21 per cent of the Canadian total, compared with 8 per cent for the other two regions.[4]

HOW THE GROWTH OF FOREIGN CONTROL IS FINANCED

Foreign controlled firms are financed by:

(i) the internal cash flow of foreign controlled firms in Canada;

(ii) raising of equity or debt in the Canadian capital market;

(iii) new direct investment from abroad; and

(iv) portfolio investment from abroad.

Statistics Canada has constructed a new series of data to show how foreign controlled firms financed their business between the end of 1946 and

[4] It is possible that the figures for British Columbia are now much higher than they were in the period 1965-68. Japanese investment has increased since then. Also, the fact that the criterion is taxable income may give a downward bias, since some of Japanese controlled mines in B.C. may not have started paying taxes by the end of the 1960's.

the end of 1967. Over these years, Statistics Canada estimates, as indicated in Tables 9 and 10, that the book value of foreign controlled investment increased by $24.5 billion.

TABLE 9

SOURCES OF EXPANSION FUNDS FOR FOREIGN CONTROLLED ENTERPRISES

	1946–1960		1960–1967		1946–1967	
	$ Millions	%	$ Millions	%	$ Millions	%
Capital Inflows from Countries of Principal Owners	5,316	39.2	3,631	33.1	8,947	36.5
Portfolio Investment from Abroad	399	2.9	373	3.4	772	3.1
Sub-total	5,715	42.2	4,004	36.5	9,719	39.6
Retained Earnings	4,164	30.7	4,124	37.6	8,288	3
Canadian Capital	2,631	19.4	2,334	21.3	4,965	
	12,510	92.3	10,462	95.5	22,972	93.7
Other Factors	1,045	7.7	496	4.5	1,541	6.3
	13,555	100%	10,958	100%	24,513	100%

By adding in capital consumption allowances and depletion, a complete picture of the sources of finance is obtained, as shown in Table 10.

TABLE 10

	1946–1960		1960–1967		1946–1967	
	$ Millions	%	$ Millions	%	$ Millions	%
Total from Above	13,555	59.6	10,958	51.7	24,513	55.8
Capital Consumption Allowance	8,241	36.3	9,323	44.0	17,564	40.0
Depletion	929	4.1	903	4.3	1,832	4.2
Grand Total	22,725	100%	21,184	100%	43,909	100%

Of the $43.9 billion in total financing available over the entire period, $9.7 billion was derived from foreign sources—a little more than 22 per cent. In the period 1960-67, only 19 per cent of total financing was obtained from abroad, with a corresponding proportionate increased use of Canadian sources, including proportionately greater use of retained earnings, capital cost allowances and Canadian capital markets.

According to the Department of Industry, Trade and Commerce survey based on 326 reporting firms, which accounted for more than 900 subsidiaries, the net external funds (i.e., external to the company) obtained from foreign sources between 1965 and 1969 decreased sharply as a proportion of net external funds obtained from all sources. However, this was due more to a reduction in funds obtained from foreign markets than to increased demands on the Canadian capital markets.

The implication of the above tables is clear. Firstly, they show the obvious—that even if new foreign direct investment were to be entirely excluded from Canada, foreign control would continue to grow in absolute terms, due both to internal generation of funds by foreign controlled companies and by their ability to raise external funds in the Canadian capital markets. Secondly, over 60 per cent of the financing for the expansion of foreign controlled firms in the 1961-67 period came from sources in Canada, and this proportion did not include capital cost allowance. As a result, if the government should wish to deal with the rate of growth in foreign control completely, it would not be sufficient to look exclusively at new direct investment. It would also be obliged to take account of the finances obtained from Canadian capital markets and the application by the individual firms of the internal cash-flow.

CONCLUSIONS

All the data confirm that foreign control now constitutes a very high proportion of Canadian corporate activity and that it is particularly concentrated in resource exploitation and manufacturing. Within manufacturing, foreign control is concentrated in particular industries, including most of the science-based industries, such as transport equipment, chemicals, machinery and electrical products. In 1968, according to CALURA, close to 35 per cent of the assets of non-financial firms were non-resident controlled.

As for regional distribution, it is apparent that Ontario has received a larger proportion of foreign investment in relation to the size of its economy than have other parts of the country.

The most recent Investment Position data show continued growth in foreign control and the CALURA data on ownership reveal the same trend. Based on both sources, it can be concluded that while the rate of increase of foreign control is not as great as it was in the 1950's, the trend still appears to be upward. Moreover, statistics cited on the proportionate growth in savings of foreign controlled firms suggest the possibility of further modest increases in 1968 and 1969 in the Investment Position data.

Part Two

THE DETERMINANTS OF FOREIGN DIRECT INVESTMENT

Part Two

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Chapter Three

DETERMINANTS OF FOREIGN DIRECT INVESTMENT IN MANUFACTURING AND RESOURCES

INTRODUCTION

The question of foreign direct investment has generated considerable debate in Canada, some of which has been less than informed because of a degree of misunderstanding about the nature and determinants of foreign direct investment. For this reason, this chapter seeks to analyse the phenomenon of foreign direct investment. A better insight into the nature of direct investment may help to dispel some of the misunderstandings that surrounds the subject and to focus debate on the key issues.

The analysis of foreign direct investment below suggests that the factors which determine the nature and extent of foreign investment in *manufacturing* are distinct from those in the *resource industries*. Each of these determinants is, therefore, treated separately.

This section addresses itself to the following:

(i) The factors which make it possible for a foreign manufacturer to market his goods in Canada, either through exports or foreign direct investment, and the features of the Canadian economy which have supported this penetration of foreign goods. Consideration of these issues suggests that foreign direct investment and trade have some common determinants and, therefore, understanding why trade flows will also help us to understand why there has been such a high level of direct investment by foreigners in Canada.

(ii) The factors which lead a foreign manufacturer to undertake direct investment in productive facilities in this country to supply the Canadian market, rather than producing abroad and exporting to Canada.

(iii) The broad implications and impact of foreign investment on the Canadian economy. The discussion focuses on the benefits and disadvantages which are to be examined empirically later in the study.

(iv) The nature of foreign direct investment, particularly as it relates to the major points that emerge from the preceding analysis.

(v) The determinants of foreign direct investment in the resource industries.

(vi) The multinational enterprise as a development of foreign direct investment.

(vii) Foreign takeovers of Canadian controlled firms.

THE DETERMINANTS OF TRADE AND FOREIGN DIRECT INVESTMENT IN MANUFACTURING

If a single determinant of exports and foreign direct investment in manufacturing had to be identified, it would be that of the "distinctive" capacity of the foreign manufacturer which enables him to earn additional profits by marketing his product abroad.

The concept of distinctiveness is difficult to define, but it is central to an understanding of trade and direct investment flows. It implies the existence of some particular capacity of the firm which makes it highly competitive. This might result from cheaper access to a factor of production such as capital or labour, technological superiority, or the achievement of significant economies of scale. Alternatively, the distinctiveness may lie in the existence of some real difference in a product or service or some artificial difference created by product differentiation. Distinctiveness may also result from capacities unrelated to efficiency or superiority, such as market power, which simply means that few alternative sources of supply exist. Distinctiveness, in other words, describes the quality that makes a product marketable in a foreign economy.

The importance of distinctiveness in determining the flow of direct investment or trade is revealed, in part, by the industrial distribution of foreign investment and imports in Canada. Imports and foreign direct investment in Canada are high in such industries as automobiles, machinery, electrical products, scientific instruments, chemicals, etc.

In some cases, therefore, distinctiveness may be achieved through the comparative advantage enjoyed by a company, comparative advantage being a traditional concept involving relative factor endowments and the relative costs of various factors of production. But distinctiveness is a concept that embraces other elements as well—such as a company's advanced technology, its strong market image or its market dominance—and these elements may also play a part in determining international trade and investment flows.

Increasingly, both international trade and foreign direct investment are found in industries where the distinctive capacity of the seller lies in his advanced technology, in his distinct market image, or sheer market dominance extended into another market.

The decision of a manufacturer to try to market his distinctiveness abroad, either by exporting or by foreign direct investment, is usually taken when he wants additional markets to make use of existing excess capacity or other under-utilized resources (e.g., capital). The manufacturer approaches a kind of threshold and looks for a maximum return on his next increment of production or investment. In many cases this will be abroad, where the market has not been saturated and where his distinctiveness is new.

PROFIT ON DISTINCTIVENESS

There are three basic types of "distinctiveness":

(i) Technological superiority resulting from an investment in knowledge by a firm, on which it wants to earn a return before its distinctiveness is dissipated. The public interest lies in providing a "return to the innovator" that is sufficient enough to encourage him to innovate. Any return greater than that represents an unnecessary cost to society.

(ii) Monopoly control of the inputs or of the market for the product. A degree of control over the market can also come from product differentiation which tends to limit artificially the substitutability of products in the mind of the consumer. A "return to monopoly" is not of benefit to the economy.

(iii) Possession of a resource or skill which is limited in supply, at least in the short run. The "return to scarcity" helps determine the allocation of the scarce resource and provides an incentive to increase the supply of it, if this is possible. No public benefit is obtained, however, if the supply of the resource is arbitrarily restricted in order to maintain prices at a high level.

Each of the above characteristics involves some "distinctiveness" for the manufacturer. The resulting return can be of short or long duration. Paying such returns to the distinctiveness may be socially beneficial as in the payment for knowledge or, to some extent, to scarcity. To the extent that the return is greater than that required to induce the needed investment, it may not be desirable for the economy.

The manufacturer's return may be enhanced if he enjoys significant economies of scale or if the expenses of developing the technology, designing the production facilities, building the market image, etc. have already been absorbed for the home market. They represent a sort of "sunk" cost. A sale in a foreign market (as a result of trade or foreign direct investment) at a price which covers the costs of manufacturing and distribution, an acceptable profit and also some allocation to sunk costs, thus embodies an attractive return for the manufacturer. To the extent that this return exceeds that required to bring about the investment in question, it too represents an unnecessary cost to Canadian society.

The existence of these returns to the foreign manufacturer does not lead to the conclusion that he is therefore acting as an exploiter and that

the host economy does not benefit. The host economy may be considerably better off by paying this price, since it could be much more costly to develop the product using its own resources. It does lead to the conclusion that "excess" returns may exist in some cases and that, as a sound business judgment for the economy, Canada may be paying more than necessary for what it is getting.

SPAWNING DISTINCTIVENESS: THE HOME ECONOMY

The Canadian economy has tended to produce relatively few manufacturers with a distinctive capacity. The United States economy, on the other hand, has produced a good many and their products are marketed internationally by trade and direct investment abroad. Factors which tend to generate such products include a high level and rate of growth of per capita income, the size of the market, a highly competitive environment, and the cost of labour.

At the consumer level, high and rapidly growing real incomes, large markets, and a competitive environment create wants for increasingly sophisticated products, encourage innovation and product differentiation, and provide better opportunities for new products to gain acceptance. The size of the market influences the rate of development and adoption of new products, since a larger market holds out the prospect of greater profits. Consequently, large, wealthy, growing and competitive markets are more likely to foster innovation. In addition to the factors mentioned above, the development of producers' goods is influenced by a number of other broad factors: the educational system and the abundance of skilled labour; growth aspirations; the quality of the specialized institutions and services that support entrepreneurs; and high wages, which induce more capital-intensive production and more advanced technology and are, in turn, a product of these developments.

These underlying determinants have favoured economies like that of the United States—and increasingly Europe and Japan as these economies develop—as sources of distinctiveness. A smaller industrialized nation like Canada tends to find its comparative advantage for international activity in undifferentiated manufactured goods such as steel or aluminium ingot.[1] These tendencies, however, are not immutable and governments can and do influence or alter these underlying determinants.

THE RECIPIENT ECONOMY

The host economy must be basically open or receptive to the products offered by the capital or goods exporting company. For this receptiveness to exist in the case of consumer goods, conditions and characteristics similar to those of the "home" economy must exist, e.g., similar consumer tastes, real income, and spending capacity. Costs of labour, production techniques, factors

[1] Natural resource extraction is considered in this chapter.

of production and educational levels influence the receptiveness to or appropriateness of foreign producers' goods and technology. Physical proximity also has a significant influence on the receptiveness of an economy to distinctive foreign products.

Historically, Canada has not sought to keep out foreign products, although it has sought to discourage the inflow of a number of goods in the form of imports through high tariff barriers. Nevertheless, Canada has provided fertile ground for the sale of products of United States origin. United States based firms have seen Canada as a logical extension of their market, given the cultural and social similarities, political stability, physical proximity, benefits of advertising spill-over, and the increasing ease of access as communications and transportation improve. While the Canadian "openness" has been reduced to some extent by tariff barriers, these did not preclude the profitable extension of United States based firms into Canada by direct investment.

To this list of factors which have facilitated foreign penetration of the Canadian markets should be added the existence of political and economic structures which did not conflict with these underlying tendencies. Both trade and direct investment presuppose a degree of institutional cooperation (e.g., banks and capital markets), and governmental attitudes which make it safe for private business transactions to occur.

This analysis is not meant to imply that an economy is exclusively either a creator or recipient of distinctiveness. An economy may develop distinctiveness in one area and purchase it in another. As Europe and Japan continue to develop, there is a growing degree of penetration by each area of the economy of the other, and of the United States economy as an outcome of the process of international specialization.

In summary, it can be said that trade and foreign direct investment in manufactures have many common determinants (e.g., similar tastes, comparable stages of industrial development, etc.) i.e., it is economies that are alike that relate in the field of manufactures. But what makes one country the exporter or investor and the other the importer and recipient is the possession of distinctive capacities. It is large, growing, wealthy and competitive economies that tend to spawn distinctiveness. The exploitation of distinctiveness tends to bring an added reward based on superiority, scarcity or monopoly, but this does not necessarily mean that the host economy does not benefit.

DETERMINANTS OF FOREIGN ENTRY BY INVESTMENT OR TRADE

The preceding section suggested that trade and foreign direct investment have some common determinants and that they are to some extent alternative routes for a foreign firm to enter a host market. Historically, these two techniques have not infrequently constituted successive steps, that

is, a foreign firm first secures the foreign market through trade and subsequently enters to assemble or manufacture the product involved. This section seeks to identify the factors which lead a firm to choose investment over trade as the route to enter Canada.

There appear to be three broad groupings of factors:

(i) those related to the profitability and market position of the foreign firm with the distinctive advantage;

(ii) those related to the host (Canadian) environment; and

(iii) those related to the home environment.

FACTORS RELATING TO THE FIRM WITH THE DISTINCTIVE CAPACITY

The basis on which a decision is reached by a foreign company to undertake direct investment in Canada is similar to that on which a Canadian controlled company reaches a decision about where to undertake the expansion of its domestic production. When new markets require expanded productive capacity, a firm must decide whether the profit from the expansion will be greater in a new location or in expanding existing facilities and shipping to the new location. For example, it may be more profitable to build a new plant in Vancouver, rather than to enlarge an existing plant in New York (or Ontario) and ship to Vancouver. In deciding to invest abroad rather than export, it is important to realize that the manufacturer can still capture significant economies of scale, through his home based operation, e.g., by exporting components and intermediate goods, by using existing plant and production designs, and by centralizing financing, marketing and other administrative functions.

The choice of investment over trade presupposes, of course, that the distinctive capacity is transferable and that the investor has the managerial capability and other resources necessary to move abroad. But even if the foreign proprietor does not have the capital and managerial resources to expand abroad, he may still be able to penetrate foreign markets to a greater extent by licensing or franchising an independent domestic firm than by exporting.

Foreign investment tends to be riskier than trade (or domestic investment) because of foreign exchange risks, uncertainty about foreign governmental attitudes, less complete information about the local market, the dangers of training local personnel who might later establish themselves as competitors, cultural differences, and so on. This greater degree of risk tends to lead the foreign investor to seek a "premium" return.

Cost Factors

An important determinant of the decision about whether to invest is the relative cost of production in Canada in comparison with the cost of producing in the "home" economy and then shipping to Canada. The prominent cost considerations are: tariff barriers or other trade barriers;

transportation costs; cost of production for the manufacturing or assembling activities contemplated in Canada—most particularly comparative—labour costs; and the costs of other factors of production.

Canadian tariff barriers were, of course, instituted to foster the development of an industrial base. These trade barriers did not, however, reduce the various economic and non-economic factors tending to integrate the demand patterns of Canada and the United States. In addition to access to the Canadian market, direct investment offered access to Commonwealth markets as a result of Imperial Preference introduced in the thirties.

Historically, the Canadian tariff seems to have been a significant cost consideration. Between 1870 and 1887, eighty-two United States firms established in Canada. Twenty-one of these were established in 1879 (a year of significant tariff increases) and most of the eighty-two were established in the post-1879 period. Lower labour costs and access to cheaper inputs, such as hydroelectric power, have also probably played a fairly important role in fostering direct investment in Canada. Transportation costs do not appear to have been a significant factor for most goods.

Marketing Factors

While a foreign firm will generally prefer to remain in its home market if cost savings are not significant, the necessity to manufacture local adaptations of a product to meet requirements or tastes in the "host" market may lead the manufacturer to enter through direct investment. Location in the host market also tends to help the foreign producer win a greater share of the market. Local purchasers are less conscious of the "foreignness" of the product and are less likely to be concerned about possible deficiencies in servicing.

Apart from the necessity of being "in" the market for reasons of servicing or because of the nature of the commodity (e.g., bread must be fresh every day), these marketing factors do not appear to have been a significant determinant of direct investment in Canada. In the case of investment from the United States, cultural similarities, together with advertising spill-over, all but eliminated the necessity for local adaptations.

Factors Related to Market Position

A foreign producer can establish a market position in Canada either through trade or investment. But there are some circumstances that will lead him to choose the investment route that are related more to market factors than considerations about comparative cost advantages. He may hear that a competitor is thinking of establishing production facilities in Canada and decide to move first to prevent his competitor from gaining an upper hand in the market. Or his competitor may have already moved to Canada and he decides he must follow. Alternatively, a foreign investor may locate in Canada to foreclose the possible development of a Canadian firm which could become

a competitor not only in the Canadian market, but also potentially in other world markets—including the home market of the investor. Thus, foreign direct investment may occur as part of the global strategy of an investor to protect his markets from rival entry or to prevent a competitor from gaining a dominant position in a market of interest to him.

The threat to the original producer varies with the degree of distinctiveness of his product. At the early stages of the product life cycle it will be more unique. As time passes, imitations or alternative brands emerge. This is a particularly important consideration for a producer whose distinctiveness is based on technology, even if it is protected by patents. Most patents can be circumvented, especially by firms large enough to engage in expensive litigation. It is usually more difficult to dislodge distinctiveness that is based on product image, product differentiation and marketing skills.

These factors relating to the market position of the foreign investor have probably been quite important in Canada, at least for investment from the United States.

THE HOME ENVIRONMENT

Governments have traditionally encouraged exports as a means of enlarging the domestic industrial base and increasing employment. In some instances, home governments also encourage direct investment abroad by various tax provisions, by underwriting the risks involved or by encouraging investment as part of a foreign aid programme. Only the first would seem to have affected direct investment in Canada in recent years, with some United States tax laws making it advantageous for United States companies to invest in this country.[2]

Another contributing factor in the case of the United States may be the operation of United States anti-trust legislation. By limiting merger activity at home, it may have led corporations to look for expansion opportunities abroad.

Direct investment may also displace trade as the costs of production at home tend to increase in response to demand pressures arising from increasing exports. As a result, production abroad begins to appear more attractive than exporting to the host economy.

A related factor concerns the shift in the exchange rate relationship between two countries induced by heavy exports from one and imports by the other. It will be recalled that during the 1950's, demands for United States exports contributed to the emergence of the "dollar gap" and downward pressures on the exchange rate of other currencies in relation to the United States dollar. Similar pressures—largely the result of strong export performances—appear to exist in the case of Germany and Japan today.

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[2] It is significant that some foreign governments (the United States government in particular) appear to have come to the conclusion that foreign direct investment is not an unmitigated blessing for the home country. The United States government, for example, is concerned about the balance of payments effects of foreign investment and United States unions are concerned about the "exporting" of jobs along with the capital and technology.

The result is a tendency for export sales from the home economy to become less profitable or less competitive as they become more expensive in foreign markets. In these circumstances, a company may find it more profitable to build a plant abroad, which it can now do more cheaply than before because of the increased value of the currency of its home country, to produce goods at lower cost for direct sales in the foreign market (and possibly also for export). In addition, the home government may encourage direct investment as one way of offsetting a current account surplus to bring its balance of payments into equilibrium.

The institutional support for direct investment in the home economy should also be noted. For example, the efficiency and dynamism of the New York capital markets have probably been a considerable factor in fostering United States direct investment abroad.

HOST (CANADIAN) ENVIRONMENT

Assuming that a foreign manufacturer is giving consideration to locating some degree of manufacturing activity abroad, two factors that play a part in determining the extent of that activity are the size of the prospective market and the willingness of the host country to sanction that activity. Canada has tended to be a relatively attractive location for many kinds of foreign direct investment on both counts.

In addition to these determinants, a number of other factors specific to the Canadian environment have been important. Since Confederation, consecutive governments have emphasized the need for rapid Canadian development. This emphasis on growth led to the emergence of important "gaps", as the demands of the economy normally exceeded the supply of domestic resources—human and non-human. The required technology was not available from Canadian sources; capital to finance a particular venture or category of activity could not be found (or Canadian financial intermediaries were unable or unwilling to fund certain undertakings); entrepreneurial talent to identify and fill a particular need in the Canadian market was often lacking; and Canadians tended to look to foreign sources (the United States in particular) for certain goods or services because of their real or supposed superiority. The existence of these "gaps" made it considerably easier for foreign investment to penetrate the Canadian market.

Under the system of international specialization that has evolved, there will always be gaps in the economy which can be filled more efficiently and at lower cost by foreign direct investment, licensing or importation of goods and services. The filling of such gaps from abroad can free domestic resources for employment in activities which Canada is more capable of undertaking efficiently. It is likely, however, that some of the gaps in Canada's economy are being filled from abroad, not because of any inherent domestic disadvantage, but because of shortcomings in national economic policies and/or institutions which have prevented Canada from

realizing its potential to produce some goods and services, now being imported, at no greater or even less cost.

It is significant that needed technology was not purchased (e.g., through licences) and needed capital came in the form of direct investment, rather than portfolio investment, to support the growth of Canadian firms. This suggests that the gaps were more than financial, that they were in fact entrepreneurial or technological in nature. While foreign direct investment often fills gaps and provides a missing ingredient of growth, it can also stultify and aggravate existing gaps, especially if the Canadian economy could have developed these capacities on an efficient basis over time. Thus, in some cases, foreign direct investment reflects sound international specialization and efficient resource allocation; in other cases, it merely reflects the market power of the foreign investor or deficiencies in the Canadian business environment arising from shortcomings in domestic economic policies or institutions.

The reasons for the existence of an entrepreneurial gap is a complex psychological and sociological question. At least three explanations can be suggested:

(i) Canada's colonial history may have led to a mentality of looking abroad for the new and the better in goods and services.

(ii) The Canadian education system, especially in Quebec, was more heavily geared to a classical curriculum than the United States and it did not turn out the engineers and business graduates needed to lead the development of an entrepreneurial and innovational society.

(iii) Entry to financial institutions and, to some extent, to other large businesses tended in the past to be restricted to individuals having the right social connections. This lack of social mobility in Canadian society may have played a part in repressing the growth of indigenous innovation and entrepreneurship.

It should not be concluded that this analysis suggests that Canada could in the past, or should in future, become self-sufficient and do everything for itself. Some of the "gaps" identified may be a reflection of the economic soundness of relying on foreign sources to fill certain needs which are more effectively performed abroad. However, it is clear that some of the gaps identified appear to be the result of deficiencies in Canadian public policy and/or private institutions and help explain in part why the government has had to introduce various types of programmes to support Canadian economic development. Later sections of this report consider possible policies to help overcome these deficiencies.

Canadian governments—federal and provincial—have sought to attract foreign capital to meet the growth aspirations of the country. This has helped to stimulate the inflow of the various ingredients of growth—large pools of capital, entrepreneurship and risk taking, technology, management "know-how" and skilled manpower. With a few notable exceptions (e.g., C.N.R., C.B.C., Air Canada), Canadian governments have relied heavily on the

private sector, concentrating their own policies on creating an environment attractive to business investment—rather than looking to public ownership as some countries have done to fill needs not met by domestic private interests. Incentives have generally been available on a non-discriminatory basis to Canadian and non-Canadian investors alike.

IMPACT OF FOREIGN DIRECT INVESTMENT ON THE CANADIAN ECONOMY

Foreign direct investment and the resources and capacities it brings with it can greatly benefit the Canadian economy. It can also bring with it significant costs, the full extent of which is not always readily apparent.

BENEFITS OF FOREIGN DIRECT INVESTMENT

Foreign direct investment has generally filled gaps in Canadian resources and capacities and by so doing has increased economic growth, living standards, jobs, tax revenues, etc. These gaps may result from either a deficiency in the Canadian supply of the relevant inputs, such as technology or management, or they may be the product of institutional deficiencies (in capital markets, for example) in moving the needed resources to the particular investment opportunity involved.

The foreign investor in some cases may add significantly to the competitive climate of the industry involved (and perhaps also of supporting industries, as he puts pressure on those suppliers to be more efficient). Indeed, foreign direct investment may be the only viable source of new competitive challenge to existing firms.

Foreign direct investment may provide export markets which otherwise would not be available to Canadian industry at that point in time.

Foreign direct investment also offers the potential for training local personnel—both managers and workmen—in new techniques which are more productive. Increased productivity leads to greater real wages and salaries. Furthermore, the skills acquired in working for a foreign controlled firm may later be made available to Canadian controlled enterprise as the persons involved change jobs and move around the economy.

Lastly the direct investment firm may locate in a region where employment opportunities are scarce. In addition to the direct economic and employment activity which direct investment represents, there are spill-over activities in supporting and surrounding industries or businesses which advance economic growth.

COSTS OF FOREIGN DIRECT INVESTMENT

The foreign investor often is in a preferred position to call on real Canadian resources because of his size, his credit-worthiness, his competitiveness or his ability to pay higher wages and salaries. In cases where the foreign com-

pany possesses a genuine superiority, this will usually result in an allocation of resources that is in the best interests of the economy. In cases where the company does not possess any genuine advantage, it may result in a misallocation of resources. In either circumstance, however, the foreign company influences the priorities and structure of the Canadian economy, often reflecting the economic and industrial objectives of a foreign government or economy which may or may not accord with Canadian objectives and priorities.

The transfer of "distinctiveness" by a foreign investor tends to involve a "package". The tying of several inputs into the foreign investment package may have the effect of raising costs to the Canadian economy above what would be necessary to purchase the distinctive capacity without the other elements of the package. In fact, the investor may be less efficient in supplying these additional inputs or may overcharge for them. For example, a foreign proprietor of a particularly attractive technology might make access to its use conditional upon the purchasing of components, the payment of a managerial fee for services or all the equity financing for the project. These inputs may be overpriced to the host economy and represent a kind of monopoly gain to the investor if his incremental cost for them is low or zero and his transfer price is set at a fully allocated cost. The tying of inputs in the foreign investment package can increase the barriers to entry for potential Canadian producers of particular components and thereby serve to stultify the development of new Canadian capacities. The tying of inputs into a vertically integrated corporate structure also creates barriers to the establishment of a Canadian owned company to produce a similar final product because in the absence of independent suppliers of components he must establish a large scale, vertically integrated operation of his own. Furthermore, the direct investment package may also carry with it a number of restrictive conditions which reduce the flexibility of the host economy and impose added costs, including export restrictions, tied procurement or limitations on research and product development.

While not strictly speaking a part of the package, direct investment can also involve the importation of certain cultural values embodied in, for example, a particular piece of technology, a particular differentiated product, a way of doing business, or employment practices.

Reference has already been made to the greater risk involved in foreign direct investment. This greater risk, together with the desire to maximize the returns by concentrating in the parent company functions for which there are economies of scale or other savings, leads the foreign controlled firm to restrict the scope of its activities and the amount of investment it commits in the foreign market as much as possible, with the result that the foreign operation tends also to be limited in scope and potential. It is, in other words, a development that is "truncated".

Truncation means potentially less decision making and activity in Canada—fewer export opportunities, fewer supporting services, less training of local personnel in various skills, less specialized product development

aimed at Canadian needs or tastes and less spill-over economic activity. It ties the subsidiary to the parent in a relationship of dependence, e.g., for technology, components and services. Truncation also increases the flexibility of the parent in repatriating profits, for example, by allowing it to change the subsidiary for components or services at a rate which is significantly above the incremental cost. Truncation is inherent in the nature of foreign direct investment. A foreign manufacturer sets up operations in Canada to extend the market for his distinctiveness. He does not set out to maximize the activities and operations of the subsidiary.

Foreign direct investment can also lessen competition in certain circumstances. Because of the risk involved and the close connection with market extension, direct investment tends to favour large firms—firms that have the necessary resources, and aim at establishing a global market position based on the market and economic power developed in their home economy. In other words, much foreign investment merely represents the extension of foreign oligopoly and world concentration into Canada. This, in turn, means that Canadian industry also tends to be more concentrated and less competitive than might otherwise be the case. To the extent that foreign investment is pre-emptive, preventing a potential Canadian competitor from developing, it will further reduce competition in the Canadian economy.

Foreign direct investment can act as a transmission belt for the entry of foreign laws into Canada. It can bring cultural influences which may or may not be desirable. Foreign direct investment could also create difficulties in the formation of both domestic and foreign policy and for Canada's image abroad.

THE COST-BENEFIT DILEMMA

Foreign direct investment is thus a complex combination of costs and benefits: easy access to foreign entrepreneurial talent, technology, capital and markets must be offset against truncation; the competitive stimulation in certain cases must be counterbalanced by the restrictions on competition in others; the provision of export markets in certain cases must be counterbalanced by export restrictions in other cases; increased economic growth, jobs, tax revenues, etc. must be offset against the long term effects of foreign direct investment on our industrial structure.

The foreign owned subsidiary in Canada may be no more high cost in its operations than a Canadian owned enterprise. The point is that in some cases the costs of the foreign subsidiary in Canada are high by comparison with those of the parent and often by comparison with the parent's subsidiaries in other countries as well. The question that arises is what steps might be taken to improve the costs of operation in Canada generally and thus make it possible to improve the performance of foreign controlled companies and increase the benefits they bring to the economy.

Licensing as a vehicle for the transference of a manufacturer's distinctiveness can have many of the same costs and benefits associated with foreign direct investment. The granting of a licence may be used by a manufacturer to spread his market power if he cannot afford direct investment in all markets. It may be used to foreclose entry of a potential competitor by granting him a licence. On the other hand, a licensing arrangement may allow a host economy to acquire a distinctive capacity without the necessity of bringing in other unneeded inputs, e.g., capital. A licensing arrangement can also lead to a more rapid diffusion of distinctiveness through the training it gives a potential competitor. Because of the similarities between foreign direct investment and licensing and other forms of contractual arrangements, much of the analysis which applies to direct investment is also appropriate to licensing arrangements.

Lastly, it should be recalled that the impact of these forces in terms of their costs and benefits will depend, in part, on Canadian tax, tariff, technology, competition and patent policies. Direct action to maximize net benefits, without attention to these surrounding policies, would consequently deal only with a part of the problem.

SUMMARY: THE NATURE OF FOREIGN DIRECT INVESTMENT

This analysis of the determinants of foreign direct investment has led us to the following conclusions:

(i) Trade and investment have a number of common determinants, the most important of which is the possession of some distinctive capacity on the part of a foreign manufacturer.

(ii) Large, wealthy, growing and competitive economies will tend to spawn distinctiveness. Recipient economies will tend to be basically similar in terms of culture, income levels, and stage of industrial development but will lack one or more of the ingredients that produce a particular distinctiveness.

(iii) The foreign manufacturer tends to choose investment rather than trade for a number of reasons related to his cost and marketing position.

(iv) More generally, changes in relative costs between the home economy and foreign markets, and home government policies have led foreign manufacturers to invest abroad rather than export.

(v) In the case of Canada, the existence of certain gaps and the receptiveness of governments tended to draw foreign direct investment into the economy.

Two particular aspects of foreign direct investment deserve special attention. These should be noted because they are very relevant to the analysis that follows:

(a) Foreign direct investment often represents a very attractive return to the foreign investor. His distinctiveness, in the form of technological superiority, market power, the possession of a scarce resource or skill, the existence of "sunk" costs, and his ability to tie together various factors in the direct investment package often may result in his earning a greater return than required to induce him to invest in Canada. The extent to which greater benefits can be obtained for Canada and the techniques for achieving this are considered in the subsequent sections of this study.

(b) Foreign direct investment involves a mixture of costs and benefits for the host economy. One of the major objectives of the remainder of this report will be to identify these costs and benefits and determine whether and to what extent this "package" can be broken up, retaining those elements that are beneficial and rejecting those that involve unnecessary costs.

FOREIGN DIRECT INVESTMENT IN NATURAL RESOURCE DEVELOPMENT

DETERMINANTS

Direct investment in natural resources shares some common determinants with investment in manufacturing. Following the previous section, this analysis will look at the determinants of investment arising out of the host (Canadian) environment, the home environment of the investor, and those determinants which relate specifically to the nature of the resource industries.

It was suggested in the previous section that the major determinant of foreign direct investment in manufacturing was the possession of "distinctiveness". The analysis below identifies backward vertical integration—the extension by a firm into the earlier stages of the productive process—as the major determinant of foreign direct investment in the resource industries.

Host (Canadian) Environment

The growth aspirations of the Canadian people and successive governments, as in the case of manufacturing, led to a demand for factors such as capital, technology, and management skills which tended to outstrip domestic supply. Consequently "gaps" were created, which in some cases were filled by foreign direct investment. Two gaps in particular seem to have been important: the financial gap and the "market" gap. Resource development frequently required enormous pools of capital which were not in all cases available from Canadian sources. This reflected, in part, deficiencies in Canadian financial institutions, and, in part, the fact that the Canadian economy was

unable to aggregate the sums required for all resource developments. Large markets were often essential to achieve maximum economies of scale in development and production, and exploration, at least in certain sectors. Both these needs were filled in many cases through foreign direct investment. It was often the provision of secure markets by the foreign investor that enabled the financing to be raised.

Canadian governments—both federal and provincial—set out deliberately to create a framework favourable to development of the resource industries through investment from both home and abroad. Not unreasonably, it was felt that government efforts to spur growth should be concentrated in those sectors where Canada appeared to have a comparative advantage. The incentives included generous tax benefits and the provision of an infrastructure necessary to develop particular resources (roads, railways, etc.).

Not only was Canada open to foreign direct investment in the field of resources, but it extended to foreign controlled interests the same incentives offered to domestically financed resource developments.

Canada's proximity to a major consumer of resources provided an additional stimulus to direct investment in these industries.

Home Environment

As in the case of manufacturing, the existence of strong and efficient institutional support for foreign direct investment was an important factor (e.g., New York capital markets).

The concern about an impending shortage of many natural resources which developed in the United States following the Paley Report and other subsequent studies warning of possible supply shortages has also been an important determinant of foreign direct investment in the resource field. A similar hunger for resources is beginning to emerge elsewhere, particularly in Japan.

Foreign governments have often deliberately stimulated direct investment abroad in the resource field. The United States government, for example, allows the deductibility of foreign exploration expenses and provides other tax incentives which have encouraged United States mineral companies to expand abroad. The absence or relatively low level of barriers to imports of raw materials in most home markets eliminates a potential obstacle to foreign direct investment.

Factors Particular to the Resource Industries

In addition to these general determinants (some of which are also determinants of direct investment in manufacturing), the following factors related to the nature of resource industries seem relevant:

(a) The location of foreign direct investment in resources is more predictable in that it goes to where the resources exist.

(b) Security of supply of inputs for a heavy investment in processing and fabricating facilities in the home country is perhaps the most

important determinant. Foreign investment is thus aimed primarily at serving the needs of the "home" market.

(c) The desire to tie up convenient world sources in order to maintain market position is also an important consideration.

The desire for both a secure supply and market position has led to backward vertical integration by foreign investors in a number of resource areas. Backward vertical integration appears to offer substantial advantages. For example, it minimizes costly build-up of inventory or shutdowns due to interruption of supplies; it facilitates the introduction of cost-saving technological change. The desire for secure supply and market position has also probably induced the search for supplies which exceed immediately foreseeable demands.

Vertical integration helps protect not only the processor but also offers security to the resource developer. An independent developer of a natural resource is in a risky position. The capital investment is generally substantial. The potential purchasers of the raw materials are few. Consequently the resource developer is in the position of having to commit large sums of money with the return being dependent on his skills as a bargainer, rather than upon open market sales to a large number of independent purchasers. While this is not valid for every resource commodity, there are numerous segments of the industry in which this confrontation has led to vertical integration in the interests of both supplier and purchaser. Furthermore, as pointed out above, without a secure market, financing for such projects is often unavailable. While there are alternatives to direct investment, such as long term supply contracts, these techniques have not been as extensively developed.

In discussing the determinants of foreign direct investment in manufacturing, it was pointed out that such investment involves a special reward for distinctiveness in many instances. A comparable kind of return exists in the case of natural resources, based either on the monopoly control of the investor or on the scarcity of the resource. In either case, the proprietor receives a greater return than the costs involved in extraction plus a return on his capital sufficient to induce him to make the investment. He receives a kind of "capital gain" by virtue of the increased value which the resources have above and beyond the costs, and by virtue of the absence of sufficient supply or alternative suppliers to satisfy all demand. Once again, these returns may be only temporary or more long lived.

IMPACT: COSTS AND BENEFITS

The benefits of foreign direct investment in resources are generally well understood. They include the following:

(i) The large pools of capital required to finance specific projects that might not always have been available in Canada were supplied from abroad.

(ii) The provision of large and secure markets has eased the problems of financing and facilitated the achievement of the economies of large scale production.

(iii) The provision of technology and managerial skills may have been important in some cases, although in general they have not been nearly as significant or beneficial as in the manufacturing area. This is partly because Canada has developed its own technology and management skills in the resource field and partly because it was relatively easy to import foreign technology in the form of machinery.

(iv) Development has been accelerated, especially in remote areas and regions which had significant disparities in terms of employment and income.

(v) High exports and the resultant contribution to Canada's balance of payments have allowed Canadians to enjoy a higher standard of living than might otherwise have been possible. However, the net balance of payments effects of any particular project is difficult to determine and in some cases may be negative (see Chapter Fifteen).

But there have been costs as well. Some of them are not as fully understood as the benefits.

(i) Foreign direct investment in the resource industries has led to a relatively greater emphasis on the use of capital over labour. A number of domestic policies (e.g., tax incentives) have contributed to this development. While jobs in resource exploitation are generally high paying, there are relatively few of them. (Mineral production in 1970 accounted for about 7 per cent of GNP but only 1.4 per cent of the labour force was directly employed in mining. It is also true, however, that resource development helped to create employment indirectly in other industries.)

(ii) Foreign direct investment to supply foreign markets with resources tends to be in a strong position to command domestic capital and real resources for reasons that were explained earlier. This could prevent potential Canadian users of these financial and real resources from expanding the manufacturing and service industries in Canada.

(iii) Canada's openness to direct investment has accelerated the nation's access to distinctive new products. But it has also meant that Canadian industrial development and priorities have in large part been determined by foreign corporate interests and the industrial policies of other governments. This has led to a greater emphasis on the resource sector in comparison with manufacturing. Furthermore, other foreign governments will put increasing emphasis on obtaining secure supplies for their resource needs and will likely continue to find Canada relatively attractive. Under these circum-

stances, external forces will continue to shape the industrial activity of Canada. A particular degree of resource development at a certain point in time may not, however, accord with Canadian objectives and priorities, including the long-run employment objectives for a rapidly growing labour force.

(iv) Depending on their ultimate balance of payments effects and the reactions of Canadian monetary authorities, large capital inflows to develop Canadian resources can exert excessive upward pressure on the Canadian exchange rate and further aggravate the problem of developing manufacturing activity in Canada. A higher exchange rate increases the price of exports relative to imports and, as a result, tends to weaken the competitive position of Canadian goods both at home and abroad. Just such pressures were generated by the large capital inflows associated with the resource boom of the 1950's.

(v) Foreign direct investment and vertical integration in the resource area have contributed to the truncation of resource activities with further processing and fabricating, in particular, taking place abroad in many cases. Truncation also reduces the development of supporting industries. Truncation is not confined to foreign controlled resource companies, however. It may also apply to Canadian controlled enterprises because of the barriers erected by other countries against the import of more fully processed or fabricated materials, or other factors. In some cases, truncation is the result of natural economic factors which dictate the location of further processing, the refining of crude oil being a good example.

(vi) Vertical integration has also made it more difficult for any independent operation to enter the industry either at the extraction or at the processing level.

(vii) While resource activity, particularly that which is foreign controlled, involves high levels of exports, many of the transactions are conducted by interrelated companies. The net benefits to Canada in tax revenues and foreign exchange earnings may thus be affected.

(viii) Resource development places heavy demands on the public purse for infrastructure in remote areas, subsidized transportation facilities and various tax incentives to the investors.

Many of the disadvantages outlined here are only partially attributable to foreign investment; many are also common to Canadian investment. Some of these shortcomings can only be rectified by changes in domestic policy.

CONCLUSION

One of the major determinants of foreign direct investment in resource industries is the benefit derived by foreign processors and fabricators from backward vertical integration. The other major conclusions emerging from

this analysis of the nature and determinants of foreign direct investment in the resource industries are not substantially different than in the case of our analysis of manufacturing. Foreign direct investment involves a mixture of costs and benefits to the Canadian economy. This mix differs from that in manufacturing on both the cost and benefit side. Large pools of capital are more important for resource development. Resource exploitation has made a greater contribution to regional development. It has resulted in greater emphasis on the employment of capital relative to labour. As in the case of manufacturing, resource development often gives the foreign investor a special return. The extraction of resources can give their proprietor a return in excess of the cost of retrieval plus a fair or normal profit.

Natural resources are in demand internationally. Canadian priorities, on the other hand, may require less emphasis on this sector or the addition of further activities such as processing and fabricating, if Canadian objectives are to be met. Canadian resources still appear attractive to foreign buyers. While the circumstances certainly vary from commodity to commodity, there would appear to be scope for increasing the benefits and reducing the costs to the Canadian economy from resource development in this country, whether Canadian or foreign owned.

Chapter Four

THE MULTINATIONAL ENTERPRISE

INTRODUCTION

The same general determinants of direct investment apply to the growth of the multinational enterprise (MNE). In manufacturing, the MNE generally invests abroad to obtain a further return on its distinctiveness. In the resource industries, the MNE tends to invest abroad to obtain assured supplies for processing facilities in the home market through backward vertical integration. While not all foreign direct investment takes place within the multinational structure, the MNE is becoming increasingly significant as the vehicle for international flows of goods and services, capital and technology.

Before proceeding, it is important to be clear on what is meant by the multinational enterprise. Various other terms have been employed to describe the phenomenon: the "multinational corporation", the "international corporation", the "transnational corporation", and the "supranational corporation". The definition adopted is of course arbitrary. What is important is the central notion it seeks to capture. For the purposes of this study, the multinational enterprise will be defined as the embodiment of foreign direct investment by a single business enterprise which straddles several economies (a minimum of four or five) and divides its global activities between different countries with a view to realizing overall corporate objectives.

PAST GROWTH OF THE MULTINATIONAL ENTERPRISE

As pointed out above, the distinguishing characteristic of the MNE is the extent of its foreign direct investment in a number of different countries, which is motivated by the same determinants as most other foreign direct investment.

Direct investment has existed for some time, mainly on a bilateral basis. It was often undertaken by a more advanced country in a colony for the purpose of developing raw materials or food-stuffs (e.g., mining or plantations). There was also some supporting direct investment in infrastructures such as railways, roads and canals. During the late 19th and early 20th century, there was a shift from investment in developing countries for the purpose of ex-

ploiting to investment in developed or industrial countries to exploit some distinctive capacity in manufacturing. Direct investment in resources still takes place, of course, but it is a declining proportion of total direct investment. For example, at the end of the 19th century (1897), 59 per cent of United States foreign investment was in resources and only 15 per cent was in manufacturing. Fifty-four per cent was in developing countries. As of the end of 1969, \$29.5 billion or 42 per cent of United States foreign investment was in manufacturing and \$25.6 billion or 36 per cent was in natural resources. Geographically, about thirty per cent of this investment was in Canada, thirty per cent in Europe, twenty per cent in Latin America and the remaining twenty per cent scattered throughout the rest of the world.[3]

Some indication of the size and growth of the MNE is given by the following figures:

(i) The book value of United States foreign direct investment increased from approximately \$7.5 billion in 1929 to \$70.8 billion in 1969.

(ii) Sixty-two of the top 100 United States corporations have production facilities in at least 6 foreign countries and 71 of the top 126 industrial corporations for which information is available are reported to have one-third of their employment abroad.

(iii) It is estimated that about 80 per cent of all United States foreign direct investment is accounted for by some 200 firms (e.g., General Motors, Chrysler, Ford, Singer, Esso, ITT, etc.). About 100 non-United States firms comprise the major MNE's of the rest of the world (e.g., Nestlé, Shell, Lever Brothers, etc.). This means that about 300 MNE's, two-thirds of them United States controlled, dominate the field of foreign direct investment.

(iv) Some attempts have been made to obtain data on the proportion of world production accounted for by MNE's. These estimates are highly questionable, as they are inflated by double counting and involve comparisons of different measures of output. But they are the best available. According to one estimate,[4] the production

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[3] Survey of Current Business, U.S. Department of Commerce, October 1970.

[4] Judd Polk, Statement before the Sub-Committee on Foreign Economic Policy of the Economic Committee of the U.S. Congress, 27 July 1970.

In a study for the Economic Council of Canada entitled *An Essay on Some Critical Aspects of the International Corporation,* J. N. Behrman estimated that the GNP of the free world was about \$2,000 billion in 1969 of which about \$1,050 billion was outside the U.S. Sales in the free world by foreign controlled affiliates he estimated to be about \$300 billion, approximately half by affiliates owned in the U.S. and half by affiliates owned elsewhere. Thus, according to Behrman, about 15 per cent of sales in the non-communist world was accounted for by foreign controlled subsidiaries.

It should be noted that Polk's estimates of sales by non-U.S. subsidiaries in the U.S. appear to be quite high. This in part accounts for the apparent contradiction between the high level of sales by non-U.S. MNEs and earlier statements concerning the dominance of U.S. controlled MNEs. It is not clear what definition of an MNE is used by Polk. It is possible he is employing a definition that embraces virtually all bilateral direct investment.

It is implicit in Behrman's text that he estimates foreign controlled sales in the U.S. lower that Polk does. It is likely that he would not estimate the foreign controlled portion of free world GNP outside the U.S. substantially differently from Polk's 26 per cent.

activities of United States subsidiaries in other countries result in well over $200 billion a year in sales. The subsidiaries which other countries control probably account for about $100 billion of production in the United States and $150 billion of production in other countries. It is further estimated that world GNP is $3,000 billion, of which $2,350 billion is produced in the non-communist world. The result is, that of $2,350 billion of GNP in the non-communist world, $450 billion, or 19 per cent, is accounted for by foreign controlled subsidiaries. Out of $1,350 billion of GNP in the non-communist world outside the United States, $350 billion, or 26 per cent, is accounted for by foreign controlled subsidiaries.

With the growth of the MNE, direct investment abroad, international production, and administered trade within the corporate stucture have begun to replace traditional forms of international trade as the model of economic relationships to achieve an efficient allocation of international resources. The foreign production of United States firms now greatly exceeds their exports. United States corporations are estimated to produce abroad (i.e., outside the United States) about $200 billion annually in comparison with annual exports of about $30 billion.[5] Another study covering the countries which receive most British foreign direct investment shows that in 1963 British direct investors produced in these countries twenty times as much as they imported for resale from the United Kingdom. Furthermore, between 1956 and 1963, purchases for resale by the subsidiaries fell by 7 per cent, whereas their local production in these markets rose by 62 per cent. In the same period, the exports of other British firms without foreign subsidiaries in these regions rose by 42 per cent.[6]

In the early stages of United States international investment, particularly in manufacturing, the Canadian market was a major recipient. The Mexican economy also received substantial United States direct investment. However, the proportion of total United States foreign investment on the North American continent fell from 56 per cent in 1897 to 46 per cent in 1914 and 32 per cent in 1968. There have been corresponding increases in United States direct investment in Europe.

It is not only United States corporations that have been expanding their international business. One study of the 500 largest industrial corporations in the world (approximately 300 United States and 200 non-United States) shows that in the 10 years following the formation of the Common Market (1957-67), United States corporations have not been outstripping their rivals. Rather, they fell behind from 1957-62 and only managed to keep pace between 1962 and 1967.[7] This reflects, in part, the deliberate

[5] Polk, *op. cit.*

[6] W. B. Reddaway, *Effects of U.K. Direct Investment Overseas: An Interim Report*, Cambridge University Press, 1967.

[7] Stephen Hymer and Robert Rowthorn, "Multinational Corporations and International Oligopoly: The Non-American Challenge," in *The International Corporation*, ed. Charles P. Kindleberger, M.I.T. Press, Cambridge, Mass., 1970.

strategy of European and Japanese governments of fostering MNE's rooted in their jurisdiction.

The reasons for the shift from resources to manufacturing and from developing to developed countries are not difficult to understand. As pointed out earlier, countries with large domestic markets and the ingredients of innovation and distinctiveness (e.g., high incomes, growing incomes, high educational levels, etc.), begin to look abroad for opportunities to expand markets for their distinctiveness. The United States has possessed these characteristics of growth and innovation for a number of years. United States government investment in research and development (R&D) during the 1950's and 1960's reinforced these basic trends and became the source of much of the product change that was subsequently spread by United States MNE's. Increasingly, distinctive capacities are being developed in Europe and Japan. Other factors contributing to these trends include:

(i) improvements in transportation and communications, which have facilitated the expansion of international investment;

(ii) foreign direct investment by one oligopolist, which has led to investment by another to prevent a competitor from gaining an advantage; and

(iii) the successful growth of MNE's, which has led many national corporations to redefine their horizons and look abroad for opportunities to increase their returns.

Two other factors have also contributed to the recent increase in European and Japanese direct investment. Both areas have developed large surplus positions in their balance of payments, with the result that their savings are in excess of their domestic requirements, and in both areas there have been significant improvements in capital markets—one of the major supporting ingredients of expansion. These two developments, in themselves, do not explain the rapid increase in non-United States direct investment abroad. As pointed out above, direct investment involves more than financial flows. However, these factors undoubtedly facilitated the growth of European and Japanese direct investment.

Another factor should also be noted. Corporations are increasingly extending their operations internationally, looking beyond the single national market because of the large sales needed to support costly research and product development. This need for global markets varies from industry to industry, but is particularly evident in aircraft, computers and other high technology goods.

NATURE OF THE MULTINATIONAL ENTERPRISE TODAY

The MNE, like the bilateral foreign investor, has its distinctive capacities to market or resource needs to fill. It generally has considerable market power and technological capabilities. But it is likely to have other important characteristics as well.

SIZE

MNE's tend to be very large. As pointed out above, 62 of the largest 100 American corporations qualified as MNE's under the definition given above. Using an alternative definition of an MNE as an enterprise with foreign content of 25 per cent or more—"foreign content" being defined as the proportion of sales, investment, production, or employment abroad—and applying this criterion to the 200 largest United States and 200 largest non-United States firms in the 1967 Fortune list, there appear to be about 75 to 85 American and a similar number of European companies which qualify as MNE's. Of the corporations reporting under the *Corporations and Labour Unions Returns Act* (CALURA), data for 1968 show that the average size of foreign owned corporations in Canada in terms of assets was \$7.8 million. The corresponding figure for Canadian owned corporations was \$1.7 million. While not all of the foreign owned corporations in Canada would qualify as "multinational" under the definition given above, the fourfold discrepancy in size is significant.

FINANCIAL STRENGTH

Size tends to be associated with financial strength. The successful big firm has large retained earnings, and easier access to financial markets. If it is an MNE, it has the ability to tap the financial resources of its subsidiaries abroad and the financial markets of various countries. This financial strength not only gives it advantages in competition with domestic firms, but it also gives it room to manoeuvre when dealing with governments, so as to avoid or minimize the effects of monetary and fiscal controls.

FLEXIBILITY

Size and financial strength give the MNE another important quality, the flexibility that comes from having a greater number of options. The MNE can serve world markets from production facilities located in a number of countries. It is thus in a better position to respond to changing conditions and circumstances, whether they arise from business operations or the activities of government. This can be both an advantage and disadvantage. The MNE can adjust the location of its production quickly if it is prepared to meet the wishes of a national government, although it may do so only with reluctance because of costs it has already sunk in productive facilities elsewhere. By the same token, however, the MNE also has the flexibility to circumvent a national government when it is not prepared to accede to its pressures. In addition, the MNE can alter the flow of earnings from subsidiaries to parent through a number of techniques, including the price at which it sells to affiliates under licensing arrangements. Its growth is not tied to the business cycle of one country. When an MNE is deciding where to put a new plant, its flexibility puts it in a particularly strong position to bargain with the possible alternative host countries.

POWER

Size and consequent financial strength, together with flexibility, confer great economic power on the MNE. It can often negotiate more favourable terms of entry to a country than another investor. It can switch production from an affiliate in one country to an affiliate in another. It can more readily circumvent local monetary and fiscal policy. It may be able to mobilize home government support if threatened. It is this power which makes the MNE a challenge for governments, not only of small countries but of larger ones as well. The OPEC countries (The Organization of Petroleum Exporting Countries) have concluded that joint action—the concentration of bargaining powers—is the only way of dealing with the challenge they see presented by the major international oil companies, virtualy all of which qualify as MNE's.

PLANNING ABILITY

Another important characteristic of the MNE is that it tends to use its power to maximum advantage. It is a long-run planning organization that realizes the value of central coordination and control. For instance, for the past several years, some 100 major world corporations have been working on a study of the future corporate environment between the years 1975 and 1985 under the aegis of the Hudson Institute. Standard Oil of New Jersey has a group of executives looking at the global environment and its implications for the company in the 1980's and 90's. In contrast, the horizons of national governments tend to be limited by the length of their terms of office. While it is easier for corporations to plan because of their simple and more homogeneous goals, their greater emphasis on long range planning may well give the MNE a further advantage in bargaining with sovereign states.

It should be noted that the multinational structure is not without its internal contradictions, which tend to prevent it from reaching its full potential. On the one hand, it must adapt to local conditions and to the demands and needs of local management in each country. This calls for a certain amount of decentralization. On the other hand, it must coordinate activities in various parts of the world; and this calls for centralized controls. The achievement of a proper balance between these two is a major problem within the multinational structure.

There is one other characteristic of the multinational enterprise which should be noted. The so-called multinational enterprises are really *national* enterprises with multinational operations. Very few examples can be found of firms whose ownership (and, less so, control) is generally spread among several countries, whose management is chosen with no regard to nationality, and whose boards of directors are balanced in accordance with the international distribution of assets. Generally, however, control rests in the home country—despite some degree of decentralization—for the important decisions regarding the location of investment, the activities to be undertaken, the international distribution of markets, and the international distribution of profits.

This is not to deny that MNE's develop characteristics which run counter to some of the national biases related to earlier stages in their development. Nonetheless, the internationalization of business has not progressed very far in the sense of "denationalizing" control. For example, of the 1,851 top managerial positions in United States companies having substantial international operations, only 1.6 per cent were held by non-Americans. This is perhaps understandable when it is remembered that MNE's still have their major assets, sales, employment, etc. in the home market. Only 11 of the Fortune list of 500 companies had over 50 per cent foreign content (as defined above) in 1965.

FUTURE DEVELOPMENT OF THE MULTINATIONAL ENTERPRISE

Even on the basis of very conservative estimates, it seems clear that MNE's will continue to grow and become increasingly powerful institutions It is estimated by one observer that the annual value of output in foreign markets by MNE's will rise from the present level of between \$300 billion and \$450 billion to over \$2,000 billion by 1990 and account for half the "free world" GNP compared to some fifteen per cent in 1969. The world's economy will be dominated by 300 or 400 super MNE's. It will not be unusual for an MNE to have one million employees. Most of these projections are based on rather simple techniques and are open to serious question. However it is probably true that the total value of production by MNE's will exceed \$1,000 billion by 1980.[8]

Assuming that the present wave of mergers throughout the world continues, encouraged by government policy in certain cases—Europe being a notable example—the size of MNE's will tend to grow rapidly. This same tendency toward greater and greater size will presumably reduce the overall number of corporations involved, simply because the world's total stock of large business firms must be expected to grow less rapidly than the rate at which mergers link them together. Thus we will probably have fewer but larger MNE's in future.

While European and Japanese MNE's will continue to grow rapidly, it is likely that United States rooted MNE's will continue to dominate the international stage for the foreseeable future. Global sales of the top 10 United States corporations are about two and a half times as large as the sales of the top 10 non-United States corporations. Although the relative size ratio declines for smaller corporations, it stabilizes from the 40th largest corporation to the 200th, with the global sales of United States controlled MNE's being about 1.6 times larger than their non-United States counterparts. United States corporations also appear to have an advantage in their administrative and organizational abilities, which gives them a flexibility and mobility that non-United States corporations do not have. This advantage

[8] Behrman, *op. cit.*, pp. 3 ff. See also Howard Perlmutter, in *Business Abroad*, April, 1969.

—developed in the early stages of the growth of national United States corporations to enable them to meet the challenges of the large and diffuse United States market—has given United States controlled MNE's an organizational head start. United States administrative and business techniques are now being adopted in Europe, Japan and elsewhere.[9] Lastly it should be noted that the United States economy during this century has manifested, to a greater extent than its competitors, those characteristics which determine innovation and distinctiveness. Furthermore, the possession of innovational capabilities tends to be self-perpetuating, with the result that the United States lead will be difficult to overcome. As noted above, however, Europe and Japan are increasingly developing their own MNE's, as a result in part of government encouragement. The continuing dominance of United States MNE's of course assumes that the United States government will not significantly extend the restrictions on the activities of the United States multinationals beyond those instituted as part of its Balance of Payments Programme. (In this context, it is notable that the legislation approved by Congress late in 1971 providing for the establishment of Domestic International Sales Corporations is aimed at encouraging exports from the United States, as opposed to production and sale by United States subsidiary companies abroad.)

In summary, it appears that, over the coming decade, multinational enterprises will continue to grow, as both United States corporations and non-United States corporations try to establish world-wide market positions and protect themselves from the challenges presented by each other. This assumes the present environment does not change in a way that is now unforeseen and, in particular, that governments will not intervene significantly to curb the growth of MNE's.

IMPLICATIONS FOR NATIONAL GOVERNMENTS OF THE MULTINATIONAL ENTERPRISE

The growing strength and importance of MNE's has implications for national governments. These are simply noted here and are developed later.

Broadly speaking the implications for national governments arising from MNE's are the same as those arising from bilateral direct investment:

(i) there is a pool of costs and benefits and the issue is one of distribution between the MNE, home governments, and host governments; and

(ii) investment by an MNE may involve a range of returns which provides scope for bargaining in order to increase benefits to the host country.

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[9] Hymer and Rowthorn, *op. cit.*, pp. 62-64.

While the challenges arising for national governments from the MNE are not qualitatively different from the challenges posed by large bilateral direct investment, the characteristics of the MNE noted above (side, financial strength, flexibility and planning ability) provide it with an added measure of power, with the result that it presents challenges which are greater, more complex, and more difficult to deal with. In particular, the ability of the MNE to play the government of one country off against the government of another is a factor that must be taken into account. It may well be that cooperation between governments will be needed in the long run if this power is to be contained.

Some of the other implications of the growth of MNE's for national governments are set out below.

INTEGRATION OF THE WORLD ECONOMY

The growth of MNE's is likely to lead to greater global integration of national economies. This will tend to reduce the abilities of national governments to control their own economic destiny. The challenge to national governments can be put quite succintly: MNE's tend to develop one industry across several countries, while most national governments try to develop several industries across one country. The two look at the world from a different perspective and have different priorities. While individual governments are concerned first and foremost with the state of their own national economies, MNE's view their own operations in more global terms. The potential exists, therefore, for growing conflict between the two. Because at present most large MNE's are United States controlled, United States oriented, and rely on their home government for protection, this state of affairs could create new areas of friction with the United States. For the government of a relatively small country like Canada this could have serious adverse consequences, for Canada could find itself confronted not only by the subsidiary and its parent but also the parent's government. Since other countries are likely to find themselves facing some of the same problems as Canada, it is possible that Canada could cooperate with some of these other countries to help strengthen its position in dealing with MNE's.

A host government is not without some leverage in dealing with the MNE in an effort to obtain a more equitable sharing of costs and benefits. Location on its territory of some investments of the MNE gives it certain bargaining power. Through the control it may exercise over these assets, it can exert some influence on the parent and perhaps the home government, as appears to have happened in the case of the Canada-United States Auto Agreement.

In the longer run, the development of MNE's, especially if they begin to lose their national identity, could lead to growing confrontations with *all* national governments. It should not be forgotten that MNE's are beginning to constitute a growing problem for the United States government by making

it more difficult for it to achieve certain major objectives. The part played by United States owned companies abroad in aggravating the nation's balance of payments difficulties led the government to impose restrictions on them. The United States government is also coming under increasing pressure from United States labour to prevent the "export of jobs" said to accompany direct investment abroad by United States MNE's. The United States concern over the behaviour of MNE's rooted in that country foreshadows a longer run possibility, namely that the MNE will become a power in its own right, not particularly tied to any one national jurisdiction—except perhaps by reason of incorporation.

Some observers have welcomed the development of the MNE as a device for integrating the world economy and eliminating poverty in the developing world. They have stressed the advantages of economies of scale and suggested that the MNE will become a powerful force in allocating capital efficiently and spreading technology from advanced to developing countries through its superior organizational ability. The MNE is pictured as an institution spanning the entire globe, producing each component in a country where costs are lowest, and making technical advances and product innovation quickly and evenly available throughout the world. The MNE would thus lead to international equalization of standards of living. It is even predicted that the MNE will eventually supplant the nation-state as the post-industrial form of social organization.

It is by no means certain that all of these developments are likely to occur. The theory of international trade postulates a tendency towards the unification of the world's living standards and the eventual eradication of poverty. However, the world of reasonably perfect competition—on which the theory of international trade is based—simply does not exist in practice. There are imperfections in the international marketplace and these are further magnified by the intervention of national governments in a variety of ways to achieve a variety of objectives. Governments have been unwilling to allow national resource allocation to be determined solely by the international marketplace. They have fixed exchange rates, put up tariffs and other trade barriers, and manifested a determination to protect and increase the welfare of the population in their jurisdiction. By interfering with the operation of the "equilibrating mechanisms", they have prevented the theory of competition from fully proving itself. There is no reason to believe that national governments will behave any differently in the face of the MNE. Given the existence of national biases, it is unlikely that foreign investors and foreign governments will be completely neutral as to the location of activities and profits. In any event, differential rates of growth in population mean that more industrial activity will be needed in certain areas to provide jobs for a rising population. It should also be noted that there is no reason to assume that international uniformity of products, resulting from the growth of MNE's, is a desirable objective.

There is another point worth noting in this connection. If MNE's were to develop to the point where they become the major organizers of production in the world, they would undoubtedly wield substantially more power than they do already. But power responsible to whom? At the moment power is wielded largely by national governments responsible to their electorates. In a world dominated by large and powerful MNE's, to whom would non-elected boards and management of multinational enterprises be responsible? Domestic corporations are generally subject to national control, but there is, as yet, no international legal order which could control MNE's.

ADMINISTERED MARKETS

As pointed out above, the multinational enterprise is replacing the market as the method of organizing international economic exchanges. The growth of the MNE has led to increasing rigidities in both domestic and international markets. Administered decisions with regard to prices and the allocation of production are becoming more prevalent. Such decisions may make good corporate sense, but are not necessarily in the best interests of the economy generally. MNE's are less responsive to macro-economic tools such as monetary and fiscal policy. They use their extensive market power to create wants and ensure their own growth, without regard to social costs. In these circumstances, governments cannot rely on the "invisible hand" to give their country an equitable share of world growth and distribution of wealth. The situation is further complicated by the fact that other governments are intervening in the operations of MNE's in an effort to have them locate more activity in their respective jurisdictions. If Canada abstains from these practices, or does not put itself in the position to influence the activities of MNE's, there is the risk that bargains will be made at Canada's expense. The characteristics and the capacities of the MNE must clearly be taken into account by national policy.

PERPETUAL DEPENDENCE

It was suggested above that the MNE is a perpetual power centre of innovation which percolates down to the host economy in due course. To the extent that MNE's are growing in importance, this suggests that Canada should seek to develop some MNE's of its own where this is economically feasible and beneficial. This notion is examined later in this report, although it is pointed out that this development is not an unmitigated advantage. Canada's small market tends to give it less holding power over the activities and development of the MNE than do the new "host" markets into which Canadian-based MNE's are likely to expand. Canadian MNE's can, therefore, present problems for Canadian economic policy similar to those arising from MNE's that are based abroad.

POSSIBLE COURSES OF ACTION

It seems clear that the rise of the MNE creates a new situation that requires new powers in the hands of the government. Even though they can make an important contribution, it is unlikely that the traditional tools of controlling the business environment—tax, tariff, competition, and monetary policy—will provide an efficient means of achieving these and other goals.

There appear to be three broad possible courses of action, or some combination of them, open to national governments to meet more directly the challenge of the MNE:

(i) resistance to the MNE where it adds nothing to national economic objectives;

(ii) international cooperative action between governments to control its activities and, failing this,

(iii) national measures to ensure that the host economy derives maximum benefits from MNE operation, and that their development is compatible with national economic goals.

Chapter Five

FOREIGN TAKEOVERS OF CANADIAN OWNED COMPANIES

A particular aspect of direct investment from abroad involves the acquisition by foreign interests of domestic companies previously controlled by Canadians. This chapter is concerned with examining the number of foreign takeovers only for those portions of the economy to which the Combines avenue for foreign control and, finally, the policy implications of this development.

NUMBER AND IMPORTANCE OF TAKEOVERS

The Office of the Director of Investigation and Research under the *Combines Investigations Act* records foreign takeovers of Canadian firms. This source, unfortunately, is not comprehensive. For one thing, it records takeovers only for those portions of the economy to which the Combines legislation applies and thus excludes many service sectors. Second, it relies on public sources, not on any statutory authority requiring the purchasing or acquired firm to report. As a result, it may not record all acquisitions, even for those parts of the economy to which the Combines legislation does apply (although it probably does record virtually all large takeovers). Third, it does not show the value of the firms taken over, the way in which the takeover was financed or the reasons for the acquisitions. Finally, the data do not indicate whether the firm being bought is Canadian controlled or already foreign controlled, although in the great majority of cases it is Canadian controlled.

This source has been supplemented by a special study published by the Economic Council of Canada in 1969. This was based on data made available by the Combines Office from an official questionnaire which it sent to firms known to have made at least one acquisition in the years 1945 to 1961 and to be conducting business in a sector of the economy to which the Act applied. This survey asked questions about the value of takeovers and the reasons for them. Some of these data and the more recent Combines Office statistics are combined in Table 11 below.

TABLE 11

MERGERS INVOLVING A FOREIGN OWNED OR CONTROLLED ACQUIRING COMPANY

Year	Number	Value*
		$000
1945	23	17,371
1946	15	7,913
1947	13	4,401
1948	14	4,433
1949	11	5,638
1950	9	9,544
1951	19	37,568
1952	17	16,074
1953	25	30,243
1954	43	83,794
1955	56	147,346
1956	54	162,224
1957	35	94,406
1958	60	99,011
1959	66	72,144
1960	93	279,000
1961	86	170,401
1962	79	Not available (n.a.)
1963	41	n.a.
1964	80	n.a.
1965	78	n.a.
1966	80	n.a.
1967	85	n.a.
1968	163	n.a.
1969	168	n.a.
1970	163	n.a.
1971	130 (p)	n.a.

*Total price paid.
(p) Preliminary.

From the above, it will be apparent that through the years there has been an increase in the number of foreign acquisitions with a new plateau reached in the period 1968-1970.

Related information has been provided by Statistics Canada, which has been recording all takeovers that have come to its attention—namely those for which the financing has been through capital imports or exports (the latter for reverse takeovers). Hence it excludes takeovers financed through the retained earnings of foreign controlled firms already in Canada, through borrowings in Canada or through the swapping of shares. In other words, it is incomplete as a measure of takeovers. Nevertheless, it is of some value as an indicator of the proportion of capital inflows which is used to take over Canadian concerns, rather than to start up new concerns or to expand established ones. The only figures available are for the four-year period 1966 to

1969. In those years some $450 million of the capital inflow was used to acquire Canadian controlled firms. At the same time, reverse takeovers were less than one-third as great, totalling $125 million. The net flow of $325 million was equal to one-eighth of the net direct capital inflow of about $2.7 billion.

The figure of $450 million, it should also be noted, was substantially higher than the cash payments for acquisitions in any four consecutive years in the 1945-1961 study, suggesting that the value of takeovers has also risen substantially since the 1950's.[10]

THE IMPACT OF TAKEOVERS ON THE GROWTH IN FOREIGN CONTROL

The study published by the Economic Council of Canada also attempts to measure on a sector-by-sector basis, the proportion of the overall increase in the book value of foreign controlled firms between 1945 and 1961 which was due to takeovers. The method was to add the book value of all Canadian firms acquired by non-residents in the period 1945-61, using the value of the acquired firm at the actual time of acquisition. It then compared the totals for each sector to the book value of assets in these sectors controlled by non-residents in 1962.

For the manufacturing sector, the study shows that the value of assets of Canadian controlled firms taken over by non-residents from 1945 to 1961 totalled $1.4 billion, representing twelve per cent (at constant prices) of the total value of assets in manufacturing controlled by non-residents in 1962.

In this study, no account was taken of the growth in the book value of the acquired firms between date of purchase and 1962. Furthermore, some of the firms represented in the book value of assets controlled by non-residents in 1962 were undoubtedly acquired in earlier periods. For these reasons, the twelve per cent figure understates the significance of takeovers as an avenue for the growth in foreign control. The comparable figure of two per cent in the mining sector is probably also an understatement.

Within the manufacturing sector, the industries in which takeovers were greatest in 1945-61 were petroleum and coal products ($460 million), primary metal ($217 million), paper ($143 million), food and beverages ($126 million) and non-metallic mineral products ($119 million). Taking the total value of assets of firms acquired by foreigners in 1945 to 1961 as a ratio of the value of assets controlled by foreigners in 1962, the largest were leather (57 per cent), non-metallic mineral products (28 per cent), wood (25 per cent), printing and publishing (17 per cent), petroleum and coal products (16 per cent) and food and beverages (15 per cent).

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[10] The value column in Table 11 includes cash payments, value of stock payments, value of debts assumed and value of other considerations. See Grant Reuber and Frank Roseman, *The Take-Over of Canadian Firms, 1945-61*, published by the Economic Council of Canada, 1969, p. 192.

The above data, although less comprehensive than desirable, at least do make clear that takeovers have been a very significant element in the growth of foreign control of Canadian business, particularly in manufacturing.

REASONS FOR TAKEOVERS

The reasons for extensive direct foreign investment in Canada were discussed previously. Therefore, the discussion below focuses mainly on the reasons why a foreign businessman might prefer to enter the Canadian market by acquiring a Canadian firm rather than starting a new enterprise. While no current quantitative analysis is available on the relative importance of the several reasons for extensive takeovers, the Economic Council study does shed some light on this subject. In reply to the Combines Office questionnaire, the reasons given by acquiring firms in order of importance are set out below, divided into two categories. The first deals with the reasons why acquiring firms were in the market to buy; the second, why acquired firms were willing to sell. The first includes:

(i) the greater speed and reduced risk that acquiring an existing firm permits, including access to established marketing channels or to assured markets;

(ii) the possibility of acquiring established or unique capabilities, such as a good man or management team, specialized technology or know-how, necessary licences or permits from regulatory authorities, brand-names or trade-marks;

(iii) obtaining quick access to, or precluding a competitor from getting quick access to, sources of supply, market outlets, and for other reasons aimed at reducing competition; and

(iv) miscellaneous reasons, including taking advantage of tax laws, getting control of liquid assets, etc.

The above reasons all relate to the demand for Canadian firms by foreign companies. Those below focus on the supply side—on the fact that many firms were for sale. Indeed, in replying to questionnaires, many acquiring firms emphasized as a first reason for their purchase the availability of the acquired firm. More specifically the supply reasons included, again in order of importance, the following:

(i) the owner wished to retire;

(ii) the firm was in financial or competitive difficulties;

(iii) the need for liquid capital, either for expansion or to pay inheritance tax.

In addition to asking why the foreigner might prefer to buy an existing firm, instead of starting from scratch, it is also worthwhile asking why a foreigner, rather than a Canadian, was acquiring the firm. One reason may be

that the real cost of purchasing the firm is greater for a would-be Canadian buyer than a foreigner. For instance, the cost of capital is normally greater in Canada than in the United States. It may, therefore, be less expensive for an American than a Canadian owned company to acquire funds—unless the Canadian company is able to borrow in the United States on comparable terms. United States tax provisions may also give an advantage to an American company. For example, it appears that a more attractive deduction for tax purposes is available to a United States owned company undertaking petroleum explorations in Canada than is available under Canadian tax law to a Canadian company, which of course could make no claim for the United States write-off if it were Canadian owned.

Prior to the recent reform of domestic income tax legislation, United States firms were also reported to enjoy a marked advantage because of their right to deduct from taxable income interest paid on funds that were borrowed to finance the acquisition of another firm, a right that was not available in Canada. The effect allegedly was to make it cheaper for an American than a Canadian company to finance takeovers, although this advantage does not appear to have been of great significance. In addition, it appears that United States businessmen may be willing to pay more for a firm than their Canadian counterparts because the historically lower interest rate structure which has prevailed in that country has in turn accustomed United States businessmen to accept a lower rate of discount on funds loaned over a period of time than Canadians. Yet another possible reason why a foreigner may be willing to pay more is that he may have greater efficiency, or some other distinctive advantage, which enables him to project higher profits from the acquired Canadian firm than any potential Canadian buyer.[11]

IMPLICATIONS OF TAKEOVERS

Notwithstanding the lack of full information, some generalizations can be made about foreign takeovers. Firstly, foreign takeovers often do not result in any significant growth in Canadian employment. Nor do they necessarily release funds to be used elsewhere in the Canadian economy for creating jobs. For example, payment received by the seller is often wholly or partly through share swaps. In effect, this means that the foreigner takes control of a Canadian enterprise with the Canadian acquiring a share in the foreigner's Canadian subsidiary. Alternatively, the funds used by the acquiring firm may actually be borrowed in Canada, also implying that no net new funds are being released.

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[11] As for reverse takeovers, Canadian firms have been repatriated for a mixture of reasons; to save the jobs of workers when the foreigner decides to close down; because the foreigner became uneasy about the Canadian environment; because a Canadian decides to move into a particular industry and offers an attractive price; because a U.S. controlled subsidiary has to be sold off because of a U.S. anti-trust ruling. More information and further study are needed in this field.

Even if the non-resident brings his capital with him and pays the seller in cash, and the seller subsequently invests the capital in job creating activity, this may add nothing if the Canadian government has borrowed money on the Canadian capital market to buy the foreign currency of the non-resident to achieve its exchange rate objectives. In that kind of case, the same impact could be had if there had been no takeover, and if the Canadian seller had borrowed directly the money which was required to start the new job creating activity assuming the Canadian was sufficiently credit-worthy to borrow the funds.

Another possibility is that a Canadian seller may receive only a small initial payment with additional payments to come from future earnings. The Canadian, even if paid in cash, might invest abroad or use all or part of it for consumption. In all of these possibilities, no new jobs are being directly created. Indeed, even if he deposits the money in an institution which eventually invests it in job creating activity, the time lag can be considerable. This, of course, is not to say that in all circumstances funds released in a takeover may not be used for creating jobs elsewhere—only that the chances are significantly slimmer than is the case when a new firm is started.

Foreign firms which prefer to take over a Canadian controlled firm rather than to start from scratch are less likely to provide any net advantage to the Canadian economy. Indeed, as indicated previously, the foreigner may be buying the Canadian firm to obtain its technology, markets or management. By the same token, in purchasing a large or leading Canadian concern, the foreigner is less likely to be adding as much new competitive thrust as he would be if he were to start up a new firm or to take over a small one. In this connection, it is likely that respondents to the questionnaire downplayed the anti-competitive reasons for takeovers because of the fact that they were reporting to the Combines Offices.

In all the above comments, the emphasis is on likelihoods, not absolutes. Indeed, as was also implied above, foreign takeover obviously can involve the saving of jobs in firms which would otherwise be shut down. It can introduce new competitive stimulus, new technology, new capital, additional management capacity, new markets and the economies of scale. In some circumstances, it may also release funds for job creation elsewhere in the economy. Furthermore, although a takeover normally involves concentration of production, as opposed to new competition, this may be more appropriate in some industrial situations.

The arguments and analysis above suggest that takeovers are less likely to provide economic benefits than are new investments. Where a takeover does not provide a significant contribution to the economy, or where it involves some net cost to the economy, it seems appropriate to question the desirability of allowing the transaction to be consummated.

One complication, of course, is that there may be conflict between the private and public interests. In cases of takeovers involving no significant benefits to the public, the Canadian owners may wish to sell for perfectly

legitimate reasons and not unnaturally want the best price. At the same time, it should be observed that the government already does intervene in the economy in this way by completely prohibiting foreign takeovers in certain key sectors (e.g., banks, federally incorporated financial institutions, broadcasting, etc.) and by blocking certain domestic mergers through competition legislation. Furthermore, most of the arguments against takeovers set out in the previous two paragraphs apply with greatest force to the taking over of firms with very substantial assets, i.e., firms which are least likely to be personal or family firms and most likely to be trading publicly.

CONCLUSIONS

The data on the number and value of takeovers and on the reasons for them are not as comprehensive as they might be, although they are probably as good or better than those that can be found in most countries. Because of the great importance of foreign takeovers in Canada, a more systematic gathering of such data should be an essential part of a better programme by government for obtaining information about foreign controlled companies in Canada.

Notwithstanding shortcomings in the data, it is evident that takeovers have been an important route through which foreign control of Canadian manufacturing activity has grown. Furthermore, it is believed that the economic benefits of such takeovers are normally far fewer than those obtained through the starting up of new firms, particularly when the takeover involves large Canadian controlled firms. For this reason, consideration might be given to the adoption of public policy establishing a degree of bias against foreign takeovers, especially of large Canadian firms, which places the onus on the prospective foreign purchaser to demonstrate the benefit of the proposed takeover to the Canadian economy.

Part Three

THE RELATIONSHIP OF BALANCE OF PAYMENTS, SAVINGS, CAPITAL MARKETS, TECHNOLOGY AND MANAGEMENT TO FOREIGN DIRECT INVESTMENT IN CANADA

Part Three

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Part Three

INTRODUCTION

There are a number of factors which have helped to shape Canada's dependence in the past on foreign direct investment. This investment has helped to fill a number of gaps existing in the Canadian economy, including those involving capital, technology, management and markets. There was, for example, an inadequate level of domestic savings, as reflected in the long series of Canadian balance of payments deficits. Canadian financial markets were not always able to mobilize the large amounts of capital needed for many of the larger resource projects, nor were they prepared to assume risks in respect of many business ventures, which, in turn, reinforced dependence on foreign capital. The relative superiority of foreign technology and management capabilities also filled gaps in the economy, but at the same time increased Canada's dependence on the foreign investor. Sometimes foreign direct investment served to open markets abroad that might otherwise not have been made available for Canadian goods, thus facilitating the achievement of greater economies of scale and a higher level of economic activity. In some cases, these markets resulted from international rationalization of production with the parent and other affiliates, in some cases from the exclusive allocation of markets in third countries by the parent to Canadian subsidiaries. In the case of resources, markets have often been provided as part of the chain of vertical integration established by the foreign parent. But foreign direct investment has also led to the exclusion of Canadian production from certain markets at the direction of the foreign parent.

There has been an important interrelationship between foreign direct investment and elements of the economy such as savings, capital markets, technology and management. While direct investment from abroad has played a highly useful role in helping to fill the gaps that have existed in the economy—and has frequently been the most efficient way of doing so—it has also tended to perpetuate these gaps by stultifying the development of Canadian capacities to perform more of these functions themselves.

Part Three is concerned with examining some of the gaps that have existed in the Canadian economy and the relationship that exists between foreign direct investment and such elements as balance of payments, savings, capital markets, technology and management. The question of markets is dealt with more fully in Part Four.

Chapter Six

FOREIGN DIRECT INVESTMENT AND THE BALANCE OF PAYMENTS

INTRODUCTION

This chapter assesses the need for further direct investment in Canada from the perspective of the requirements of Canada's balance of payments.[1]

In general, the record shows that over the past decade the current account[2] of the Canadian balance of payments has been gradually improving; that there is a very large two-way movement of capital into and out of Canada, both in long-term and short-term forms; and that foreign direct investment in Canada, as a proportion of gross (and net) imports of capital in long-term form has been becoming progressively smaller for more than 15 years.

The position on the current account of the balance of payments indicates the extent to which Canadians have to rely on foreigners to help finance Canadian economic growth. The current account is thus influenced heavily by the rate of economic growth which the Canadian economy is experiencing and by the fiscal and monetary policies of the federal government which help influence that rate of growth. The rate of economic growth required over the next several years could result in a return to a current account balance or even a current account deficit. In the latter eventuality, even assuming a deficit of $1 billion to $1.5 billion, foreign direct investment would not be essential to offset such a deficit because other means of strengthening the capital account would be available, such as long-term borrowing abroad or the restricting of certain categories of capital export.

In examining the structure of the balance of payments, particular attention is focused on the reasons for the large two-way flow of capital into and

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[1] In Chapter Fourteen the balance of payments impact of foreign direct investment is examined. It traces the balance of payments implications, through time, of individual foreign direct investments. It also deals with the implications of foreign direct investment for the management of the balance of payments policy in the short run.

[2] The current account of the balance of payments is a record of economic transactions in goods, services, and transfers between Canadian residents and residents of the rest of the world. The capital account records inflows and outflows of capital which change Canada's foreign assets and liabilities, including business investment, government borrowings, as well as any "financing" activity necessary to balance any overall surplus or deficit that arises from all other transactions. (Because of this latter activity the current account and capital account must always be in balance.)

out of Canada. It is suggested that some of the flow is not inconsistent with sound international resource allocation, but that a part of it is largely speculative "hot" money and a part due to certain deficiencies in Canadian domestic capacities. The deficiencies focused on here are those in the capital markets (a point which is picked up again in our discussion of capital markets).

STRUCTURE AND TRENDS

The structure of Canada's balance of international payments has undergone steady evolution since the 1950's, and more notably since the devaluation of the Canadian dollar in 1962 and the exemption of new issues of Canadian securities from the United States Interest Equalization Tax in 1963. The earlier pattern was dominated by relatively large current account deficits, essentially related to inflows of direct investment capital and the imports of capital goods which accompanied these investments. In recent years, merchandise surpluses have increasingly tended to balance out a rising non-merchandise deficit, and to strengthen the current account.[3] Inward movements of portfolio capital (largely for bonds) and outward movements of money in short-term forms have become much more important in the overall payments position.

These trends have been particularly marked over the past four years. The traditionally substantial current account deficit was relatively small from 1967 to 1969 and a surplus was experienced in 1970. From 1967 to 1969, borrowing abroad of capital in long-term forms by Canadians was very large and growing rapidly. The resulting substantial surplus of long term capital inflows was largely offset by very large outflows of funds in short-term form from 1966 until the later months of 1969, and by large net purchases of foreign securities by Canadians in 1966, 1967 and 1968.

From early 1969 until well into 1970, Canadian purchases of United States equities were substantially reduced and the balance of this account swung to net sales.[4] Towards the end of 1969 the outflow of funds in short-term form began to dry up. This coincided with an upsurge in merchandise exports, partly rebounding from strikes in major export industries in the late summer of 1969, but also reflecting heavy pressure of foreign demand, especially for automobiles and natural resources. These were two of the major factors which led to the unpegging of the Canadian dollar at the end of May 1970. In addition, merchandise imports were relatively weak in

[3] It should be noted that the concepts used by Statistics Canada in compiling the balance of payments data differ in one important respect from those used in some other countries, including the U.S. The retained earnings accruing both to foreign long-term investment in Canada (including direct and portfolio) and to Canadian long-term investment abroad are not shown in the Canadian balance of payments statistics. Other countries show such earnings as outflows or inflows (as dividends) on their current accounts and balance these with entries in the capital account in long-term form. In the case of Canada, if such a concept were used, the result would be to weaken the current account and strengthen the capital account by roughly $800 million per annum (based on data from the late 1960's).

[4] Since the late 1970's, this latter pattern appears to have been reversed again with the onset of the "bull" stock market.

1970. Net borrowings in long-term form were almost halved in 1970 compared to 1969, but the "basic" balance on current and long-term capital accounts remained extremely strong.

Direct investment in Canada by non-residents rose from an average of nearly $500 million a year from 1955 to 1965 and to an average of over $700 million a year since then. In 1970, it reached $770 million.

Direct investments abroad by Canadians, formerly much smaller and less regular, exceeded $200 million in 1968, 1969 and 1970. The net effect of foreign direct investment in Canada and Canadian direct investment abroad has been an inflow of about $450 million annually, with foreign direct investment accounting for around a third of the overall net inflow of long-term capital during the past four years.

In 1965 and 1966, the current account deficit rose to about $1 billion a year and the direct investment inflow, therefore, was a relatively significant element in the financing of the deficit in those years. Excluding those two years, as shown in Table 12 below, the current account deficit has been showing an overall downward trend since 1959 and in most recent years it has been amply covered by capital inflows in other long-term forms.

TABLE 12

BASIC STRUCTURE OF CANADA'S BALANCE OF PAYMENTS
($ millions)

	Current Account Balance	Net Direct Investment Flow	Other Long-Term Capital, Net	"Basic Balance"
1960	−1,233	620	309	− 304
1961	− 928	480	450	2
1962	− 830	400	288	− 142
1963	− 521	145	450	74
1964	− 424	175	645	396
1965	−1,130	410	454	− 266
1966	−1,162	785	382	5
1967	− 499	566	799	866
1968	− 107	365	1,289	1,547
1969	− 916	350	1,755	1,189
1970	+1,133	555	250	1,938

CAPITAL FLOWS AND THE CAPITAL ACCOUNT

During the last five years, Canada has enjoyed an annual capital account surplus averaging around $630 million.[5] Since moving to a current account surplus in 1970, the capital accumulation has resulted in a growth in exchange reserves.

[5] The reference to the capital accounts surplus averaging $630 million includes capital movements in short-term forms, whereas the data in Table 12 exclude entirely these movements in short-term forms.

While the capital account surplus has not been of great proportions, the actual two-way flow of capital into and out of Canada has grown enormously since the early 1950's and appears now to run to tens of billions of dollars. Capital imports affecting Canadian liabilities also appear to have multiplied many times since 1952,[6] although exact figures are not available in view of the fact that all movements of capital in short-term forms cannot be traced.

Of greatest interest here are the changes which have taken place in the long-term account. Net inflows in long-term form affecting Canadian liabilities increased from around $500 million annually to $2.5 billion annually between 1952 and 1969. In 1952, long-term direct investment in Canada was $360 million; in 1969, it was $720 million, just double that of seventeen years before. In contrast, yearly net inflows in long-term form affecting all liabilities in that period rose almost fivefold. Most of the growth occurred in new issues of Canadian bonds, especially provincial bonds, which alone accounted for a $1 billion increase. When other kinds of bonds are included, new issues of bonds accounted for around $1.5 billion of the $2 billion annual increase since the early 1950's.

The principal source of the long-term debt capital has long been the New York capital market, although borrowing in Europe, and particularly in Germany, developed rapidly around 1967. Borrowings in the United States and Europe declined sharply in 1970, probably due in part to the request of the Minister of Finance that Canadians should try to do as much of their borrowing as possible in the Canadian market.

Thus, by the end of the 1960's long-term direct investment had dropped to about 29 per cent of net Canadian capital imports in long-term form affecting liabilities. In the early fifties the comparable figure was around 65 per cent.[7]

Before assessing Canada's capacity to restrict or re-arrange these flows, it is important to take account of the factors responsible for these enormous movements. The reasons for foreign direct investment in Canada and Canadian direct investment abroad have been discussed earlier in this study and need not be repeated. As for the capital inflow in long-term form for provincial governments, municipalities and corporations, this reflects among other things the historically lower interest rates which have prevailed outside of

[6] Capital imports affecting Canada's liabilities refer to imports related to Canadian debt held by foreigners and to equity held by foreigners. It thus excludes capital imports as a consequence of repatriating Canadian capital invested abroad.

[7] The fact that direct investment has declined as a proportion of capital imports in long-term form may appear, on the surface, to contradict earlier evidence which showed that the direct investment proportion of the book value of foreign capital invested in Canada had been consistently rising. In fact, the difference can be accounted for by two factors. Of these, the most important is the retained earnings that accrue to foreign direct investment in Canada and add annually to the book value of direct investment, but which do not enter into the flows shown in the capital account of the balance of payments. Another factor that increases the book value of foreign direct investment in Canada, but which does not increase the proportion of direct investment in the capital account, is that Canadian controlled firms can be acquired without any capital inflow, e.g., through a share swap or borrowings from Canadian savers.

Canada, the convenience of borrowing abroad, the desire of borrowers to have alternative sources of capital, as well as the absence of sufficient depth in the Canadian capital markets to absorb some of the larger issues.

By far the greatest volume of movement is, however, in short-term form and in portfolio investment (which is in long-term form but which can be turned over rapidly). While not true of all movements, a good part of these flows reflects the growth of massive pools of expatriate funds seeking maximum current returns, related speculative and political considerations, institutional developments such as the growth of the Euro-dollar market, and the growing scale of internationalization of business (including financial institutions). These massive pools of money are turned over frequently. Being very sensitive to interest rate differentials, they can move at very short notice either into or out of Canada, as seen at the time of the exchange rate crisis of 1968.

A particular part of this flow which has received much attention is the large outflow since the early 1960's of portfolio capital by pension funds (around $600 million between 1962 and 1969) and mutual funds (around $1 billion in the same period) for the purchase of foreign stocks, particularly United States stocks. The reasons which these institutions give for these movements relate to the lack of sufficient liquidity in the Canadian capital markets, difficulties in achieving adequate portfolio diversification in Canada and other factors, such as relative lack of information about Canadian stocks and less stringent regulation of Canadian stock exchanges in comparison to the United States.

The factors outlined in the preceding paragraph by no means make up a complete list of reasons for capital flows. The illustrations do suggest, however, that the motives for the flows vary sharply and that some of these flows are far less important for sound international resource allocation than others. Certainly, a large part of the speculative and semi-speculative outflows, including a part of the outflow of portfolio capital, is not of great importance for the overall efficiency of the Canadian economy, even though it may have some impact on the capacity of particular firms to maximize profits.

THE RELEVANCE OF FOREIGN DIRECT INVESTMENT IN MANAGING THE BALANCE OF PAYMENTS

Any time Canada is running a current account surplus, direct investment is obviously unnecessary for balance of payments reasons. Indeed, even if Canada were to return to a fairly sizeable current account deficit (around $1-$1½ billion annual) within the next three or four years, normal provincial, municipal and corporate borrowings abroad would cover most or all of Canada's need for foreign exchange to finance such a deficit, provided that Canadian access to foreign debt capital remained open. Some limitation of capital exports—for instance, restricting some of the short-

term speculative outflows—could also help cover a current account deficit. Selling some of the present accumulation of short-term claims on foreigners is also possible. The point is that techniques are available which do not imply a serious economic cost so long as the legal power and administrative machinery are available to implement them.[8]

By moving to a more dynamic perspective, it is possible to get a more realistic assessment of the relevance of foreign direct investment in the context of managing the balance of payments. Should the current expansionary trend of monetary and fiscal policy be maintained for an extended period, the tendency would be to move the economy back toward a current account deficit. It would do this in several ways. To illustrate, the greater volume of economic activity involved would result in higher incomes, more employment and an increase in consumption. This leads to an increase in aggregate demand, which in turn is reflected in several ways. Individual consumers tend to purchase more foreign goods and services, both in absolute and relative terms, moving the trade account more toward a deficit position than it would otherwise be. In absolute terms, consumers also tend to purchase more domestic goods, which can necessitate an expansion in domestic production capacity and a need to import more machinery and other producer goods—again implying a movement in the direction of deficit—to establish the capacity to fill this higher consumer demand. The greater demand for domestic goods and services can also lead to inflationary bottlenecks, particularly as the economy moves closer to full employment, making import-replacement and export industries less competitive. In all these ways, an expansionary fiscal and monetary policy tends to lead to a current account deficit.

There are, of course, other factors which contribute to the movement toward a deficit position in an expansionary upswing. The examples given were merely illustrative. Conversely, for instance, the capital imports may in some cases precede the trade transactions which generate a current account deficit; that is, inflows of long term capital—such as provincial borrowings or foreign direct investment—can generate the same income creating effects and kinds of inflationary pressures described above. The point which is to be emphasized here is that reliance upon imported capital to finance such an expansion involves a very complex relationship between the movements of capital and the current account and that, at least in some instances, it is more plausible to view the current account deficit as an outgrowth of the capital surplus rather than the reverse.

Simplistic notions about the need to import capital—including direct investment—to balance a current account deficit during a period of expansion, are thus inadequate. In a period of relatively restrictive monetary and fiscal policy, the tendency is toward current account surplus, and direct

[8] Legislation would be required to establish an instrument to control capital exports, which would also be the case if it were considered desirable to establish an instrument to control capital imports. A tax bias might also be employed either in a general way or on a selective basis to influence the flow of funds in or out of the country.

investment is, if anything, even less essential from a balance of payments perspective.

A second factor which is relevant in the event of a current account surplus or even a moderate deficit is the limitation this imposes on Canada's capacity to absorb large net additions of capital from abroad for an extended period without adverse consequences. Assuming that the rate of increase in the money supply is determined by the government and central bank mainly on the basis of the desired growth rate (which takes account of inflationary pressures), large net additions of foreign capital could lead to difficulties in one of three ways. If the Exchange Fund Account did not purchase most or all of the foreign capital, the exchange rate would remain high or increase further, thus making Canada's import-replacing and export industries less competitive. Such a development could be particularly troublesome if the capital imports are directed toward capital intensive industries, in view of the expected rapid growth in the labour force. Alternatively, if the exchange rate were held down by a policy of encouraging exports of Canadian capital, it is likely that a high proportion of these Canadian capital exports would be in the form of short term claims on foreigners, whereas a high proportion of the foreign investment in Canada would be in the form of direct investment, involving permanent liabilities. Such a possibility is also unattractive. The third possibility is that the Exchange Fund Account would purchase the great bulk of the foreign exchange and this leads to the possibility of a more rapid expansion in the money supply than intended by the monetary authorities and the danger of more inflation than deemed to be tolerable. (If the government sought to raise the money to purchase the foreign exchange from the Canadian market, this could push interest rates up and draw in more short-term capital, thus further complicating the problem.) Perhaps the most realistic possibility is a combination of all three influences; that is, that heavy capital imports in long-term form would lead to some upward pressure on the exchange rate, some outward movement of short-term capital and more inflation then contemplated.

In any set of circumstances, the government and central bank have to take account of a wide range of factors, often conflicting, in establishing the exchange rate, balance of payments and interest rate policies. Despite this, in view of the potential difficulties described above, there appears to be a very strong reason for the government to ensure that imports of capital are kept under careful control.

DECLINING BALANCE OF PAYMENTS NEEDS FOR FOREIGN DIRECT INVESTMENT

For the present and for the next several years, at least, foreign direct investment will be unnecessary to finance a current account deficit in the balance of payments.[9] Even if Canada returns to a deficit position as a result of measures to achieve a satisfactory growth rate, there is no need for it

[9] Direct investment can also bring with it a current account deficit. See Chapter Fourteen.

to be offset by foreign direct investment. Moreover, assuming other components of the balance of payments are constant, net new foreign capital inflows tend to force up the exchange rate and make Canadian industry less competitive. There is, therefore, a potential economic price involved in importing foreign capital beyond that which may be required to offset a current account deficit. If Canada has sufficient domestic capital available to finance the growth of its economy at a rate that is close to potential, a further inflow of capital from abroad by itself will contribute nothing to economic development unless it serves a particular need for capital that cannot be fulfilled in Canada perhaps because of its sheer magnitude, or because it is accompanied by some other element that is of particular value to the economy—new technology, for example. Accordingly, it is worthwhile considering the impact of the capital being imported in direct investment form to ensure that its overall effect will be beneficial to the economy.

In this context, it must be noted that net new foreign capital investment in Canada need not have an incremental effect on Canadian growth. While the institutional mechanics are described more fully elsewhere in this study, the point to be observed here is that in trying to achieve its exchange rate objectives, the government may have to buy the imported foreign currency. This in turn often means that the federal government has to borrow in the Canadian capital market and this may lead to the displacement of alternative Canadian projects.

This does not mean that all foreign investment ought to be rejected over the next several years, since it can and frequently does bring non-financial economic benefits, for instance, the entrepreneurship required to launch a new enterprise, new technology or export markets not otherwise available. It is suggested, however, that since the exchange rate situation is such that only limited amounts of foreign capital can be absorbed satisfactorily, it makes sense to consider being selective in determining what type of foreign capital will be allowed to enter to make up for any shortcoming in Canadian savings. Indeed, even if Canada should in future require a significant inflow of capital from abroad to offset a current account deficit, it should be possible to obtain that capital in other forms than direct investment. As a consequence, Canada would still be in a position to review foreign direct investment seeking entry into this country to ensure that it came in on terms that would provide an overall benefit to the economy.

In fact, the present circumstances are very propitious for the introduction of some selective review of foreign direct investment. This would have the beneficial effect of reinforcing the measures which the monetary authorities seem likely to take over the next year or more. To the extent that their concerns about capital inflows are decreased by some modest reduction in direct investment, the necessity of being obliged to take more extreme measures to protect the exchange rate than required for domestic monetary reasons may be somewhat eased.[10]

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[10] See Chapter Fifteen for an elaboration of this point.

THE ADEQUACY OF DOMESTIC SAVINGS

The adequacy of the level of savings[11] in Canada must be measured against the nation's requirements for capital. The extent to which domestic savings fall short of, or exceed those requirements is reflected by the state of the current account of the balance of payments. A current account deficit indicates the amount by which domestic savings fall short of meeting the nation's requirements for capital and hence its need to look to foreign sources to make up the difference. The converse holds true in the case of a current account surplus. The extent to which the nation must rely on foreign savings to meet its requirements for capital plays an important part in determining the degree of control Canada can exercise over its own economic environment.

By definition, savings and investment are equal. Thus, in questioning whether Canadian savings are adequate, what is really being asked is whether they are adequate to finance the level of capital investment society desires.

The desired level of investment in turn is a function of the culture, taste and aspirations of a people and the capacity and willingness of the political and economic system to respond to them. If a society is little interested in

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[11] The concept of saving in the framework of the Canadian National Accounts reflects the amount of income generated by current production in a designated period which is not used to purchase consumption goods or services in that period. By definition, income earned from current production, but not spent on consumption, is equal to the value of non-consumed production. The non-consumed production (or savings) is used for increasing the nation's fixed capital stock and inventories. In an open economy a nation may make some of its savings available to finance capital formation of other nations or conversely may use for capital formation some of the savings of other nations made available to it. Hence, for the economy as a whole the increase in fixed capital investment and inventories for any time period is equal to the amount of domestic savings plus any deficit, or minus any surplus, on the non-resident account.

The concept of savings may be considered on a gross or net basis. The gross concept allows for amounts of saving and investment which are required to maintain the existing stock of capital intact by the replacement of obsolete and used-up capital equipment, in addition to that required to increase the stock of capital. The replacement of existing stock is achieved primarily through the "capital consumption allowance", a concept analogous to depreciation which is the proportionate charge as an expense to an accounting period based on the cost or recorded value of a fixed asset, and which is established to take account of the exhaustion of the service capacity of the fixed asset which cannot be restored by maintenance practices.

While capital cost allowance and depreciation both reflect financial provisions for the consumption of the stock of fixed capital which may be applied to (gross) new fixed capital investment (or to any other purpose), they do not generally in themselves necessarily add to the size or growth of investment. The limit of their contribution to net growth of fixed capital investment reflects the extent to which the financing made available by the capital cost allowances exceeds replacement costs. In this connection, the capital cost allowance may generate funds at a rate which exceeds physical depreciation, but this can be wholly or partially offset by rising costs of replacement. Thus, while a certain part of capital cost allowances may represent a tax deferral or abatement which may finance net growth of fixed capital, by far the largest part of capital cost allowance represents the necessary provision for renewal of the stock of fixed capital.

Net savings represent the net additions to fixed capital stock and inventory. It thus removes from both savings and investment amounts necessary to replace used-up capital, i.e., the capital cost allowance. In addition to that relatively small net addition to the nation's capital stock which may be financed from capital cost allowances, the sources of net savings are the personal sector (which by Statistics Canada accounting convention includes persons and unincorporated business), the corporate sector (government and private), governments and non-residents. By foregoing current consumption, persons, business, governments and non-residents make funds available for the expansion of Canadian fixed capital stock.

developing a comprehensive social infrastructure, for instance, it will not need as high a savings rate and can thus consume more. If it insists on a comprehensive system of schools, universities, hospitals, roads and the like, it will have to save the money to finance these needs. The absolute amounts of consumption and investment are not directly under the control of government, in that they are constrained by the size of the total national income (and availability of foreign income) being generated. But the ratio of consumption and investment can be more readily altered by the government through changes in tax levels and government expenditure patterns. The aim of much public policy is to come as close as possible to maximizing current total income, while simultaneously reflecting the consumption-investment ratio required for fulfilling the tastes and aspirations of the nation.

The discussion which follows is not premised on any major changes in the culture, tastes and aspirations of Canadians, nor on the effects of the recent changes in the taxation system. It assumes that there will be no major alterations in the investment-consumption pattern and in the tax revenues received by government in relation to national income. Within that framework, consideration is given to the adequacy of domestically generated savings for financing the level of capital investment which seems likely to be necessary.

THE NON-RESIDENT COMPONENT OF CANADIAN SAVINGS

Tables 13 and 14 below show the sources and disposition of gross savings from all sources over the past 20 years and Table 15 provides annual figures on the non-resident component in the savings account.

TABLE 13*

SOURCES OF GROSS SAVINGS
(Millions of Dollars)

	Average 1950–55	Average 1956–61	Average 1962–67	1968	1969	1970
Persons and Unincorporated Businesses**	965	940	2,257	3,339	3,485	4,182
Government	689	498	1,539	3,030	4,183	3,327
Corporate and Government Business Enterprises†	713	1,315	2,245	2,724	2,653	2,694
Non-residents	359	1,212	773	268	960	−1,115
Capital Consumption Allowances‡	2,719	4,622	6,660	8,411	9,066	9,898
Residual Error of Estimate	91	79	−212	−611	−1,031	−451
Total	5,536	8,666	13,262	17,161	19,316	18,535

*SOURCE: Statistics Canada.

**This sector includes personal and unincorporated business savings and a small adjustment on grain transactions.

†This sector includes undistributed profits, inventory valuation adjustment and capital assistance.

‡This includes capital consumption allowances in respect of persons and unincorporated business, government and corporate and government business enterprises and in addition certain miscellaneous valuation adjustments.

The table on the sources of gross savings indicates the relative degree of importance of each of the main sources and makes it possible to compare the significance of foreign sources to each of the other sources. On the disposition side, it is especially relevant that gross fixed capital formation has been more or less flat over the last several years.

TABLE 14*

DISPOSITION OF GROSS SAVINGS

(Millions of Dollars)

	Average 1950–55	Average 1956–61	Average 1962–67	1968	1969	1970
Gross Fixed Capital Formation						
1. Persons and Unincorporated Business	1,728	2,385	2,933	3,649	3,843	14,709
2. Corporate and Government Business Enterprises	2,724	4,624	7,016	9,165	10,347	
3. Government	757	1,435	2,361	2,995	3,052	3,252
	5,209	8,444	12,310	15,809	17,242	17,961
Value of Physical Change in Inventories†	418	300	740	741	1,043	122
Residual Error of Estimate	−91	−78	212	611	1,031	452
Total	5,536	8,666	13,262	17,161	19,316	18,535

*SOURCE: Statistics Canada.

†Includes value of physical change in inventories persons and unincorporated business, government and corporate and government business enterprises.

Against this background, the non-resident component can be examined in more detail. Before looking at the data, however, it is important to understand what the non-resident component represents. A part of current production is exported and thus not consumed by Canadians; at the same time, a part of consumption is from imported goods. When exports of goods and services exceed imports from abroad, the resulting surplus on the current account of the balance of payments, subject to two small adjustments,[12] represents Canadian savings made available to non-residents, with which they can add to their net capital stock. The reverse situation, where imports of current goods and services exceed exports, implies the use of non-resident savings in Canada to finance capital formation within Canada. In the simplest terms, it is the balance on the current account (not the capital account) of the balance of payments which indicates whether Canadians

[12] The adjustments are relatively small ones for capital flows due to inheritances and for capital flow involving migrants.

are net borrowers or lenders.[13] Thus the percentage figures in Table 15 represent the absolute figures in Canada's current account balance shown in Table 12.[14]

Table 15 shows both non-resident contribution to gross savings (which includes capital consumption allowance) and to net savings (which excludes it).

TABLE 15

Year	Net Percentage of	
	Gross Savings Accounted for by Non-Residents	Net Savings Accounted for by Non-Residents
1950	7.2	13.0
1951	9.6	16.8
1952	**	**
1953	7.1	13.1
1954	7.8	19.6
1955	9.9	21.3
1956	15.2	28.0
1957	16.0	31.8
1958	13.4	29.5
1959	15.8	33.2
1960	12.9	29.9
1961	10.1	26.2
1962	8.0	18.8
1963	4.6	10.9
1964	3.3	7.1
1965	7.7	14.6
1966	7.3	13.2
1967	3.7	7.2
1968	1.5	3.0
1969	4.8	9.0
1970	**	**

**In these years, Canadians were net savers for the rest of the world.

In the immediate post-war period, because of Canada's relative strength, Canadians were net lenders to the rest of the world, that is, Canada ran a current account surplus. But by the early 1950's, and continuing through

[13] In the case of a current account surplus, Canadians acquire claims on non-residents which may take many forms, including direct investment, porfolio investment or trade receivables. Canada may also reduce claims foreigners hold against Canada. To the extent that a current account surplus is reflected in an increase in exchange reserves, potential claims on foreigners are accumulated. These, however, are the financial counterparts of the real transfer of resources and may or may not be associated directly with capital formation. There is a second point which should also be noted. In Canada's balance of payments statistics, the retained earnings accruing to foreign direct investment in Canada are not included as outflows, nor are the retained earnings of Canadian direct investment abroad included as inflows. See below.

[14] However, the two small adjustments referred to in Footnote 12 would have to be made to get the exact figures.

the resource boom of the mid-1950's, Canada had substantial current account deficits and Canadians drew heavily on external savings, reflecting to a substantial degree the increased capital imports of that period. Since the early 1960's, Canada's net borrowing has been diminishing (although the year-to-year pattern has been somewhat erratic) until 1970, when non-residents began drawing on Canadian savings. This picture is, of course, by definition, the mirror image of the earlier discussion of the current account of the balance of payments.[15]

SAVINGS OF FOREIGN CONTROLLED FIRMS RESIDENT IN CANADA

The discussion above dealt with the net non-resident contribution to Canadian savings (or net Canadian contribution to non-residents), but it did not take account of the savings of foreign controlled firms in Canada. An indication of the importance of savings from this latter source has recently been provided through an unofficial estimate made by Statistics Canada for the period 1967-69. The study calculated that out of a total of $52.8 billion in gross savings accumulated in Canada during those three years, $8.8 billion was generated by foreign controlled firms. Of that amount, $3.3 billion was accounted for by retained earnings, $4.9 billion in capital consumption allowances and $0.6 billion in depletion. This means that gross savings by foreign controlled firms were equal to 16.7 per cent of the gross savings available to the economy in that period, 42.1 per cent of the gross savings of the corporate sector (excluding financial and other services and agriculture), 11.9 per cent of the net savings available to the economy and 44.5 per cent of the net savings of the corporate sector. Moreover, as indicated earlier, the savings accounted for by the foreign controlled sector for 1968 and 1969 represented a significant increase over previous years.[16]

Thus, while Canada has recently become much less dependent on savings from non-resident sources, a large part of domestic savings are generated by foreign controlled firms in this country.

CONCLUSIONS

It was pointed out that the non-resident contribution to the economy has been falling for a number of years. In 1970, Canadians acted as savers for the rest of the world. However, this does not mean that it can be assumed that in the future Canada will not again have a net need for non-resident savings—that Canada will not again require net capital imports in some form to finance a current account deficit.

[15] See Table 12.
[16] See Chapter Five.

For one thing, the economy has been operating below capacity in the last few years. Accordingly, demand for imported merchandise and services has been less vigorous than it would have been in a period of greater economy activity. Furthermore, even in periods when the non-resident contribution to savings is small, it may provide the necessary additional amount of capital expenditure needed to maintain growth of the economy close to its potential. What can be said with confidence, however, is that as the economy moves back to its full employment path, no net non-resident contribution will be needed in the next three or four years which could not be filled through means other than direct foreign investment.

While the process of resource allocation among all the competing demands will remain every bit as difficult as in the past, it appears likely that the amount of savings available will be adequate to finance all or a very high proportion of the requirements of an economy operating close to its full capacity.

Over the past 20 years, the proportion of Canadian savings accounted for by non-residents has dropped sharply and in 1970 (and for the first nine months of 1971), Canada was a net saver for the rest of the world. It is most unlikely that in the next three or four years Canada will have to rely as heavily on non-resident savings as it did from the mid-1950's to the early 1960's, so that direct foreign investment is not likely to be needed to satisfy Canada's aggregate capital investment needs.

The proportion of savings which is accounted for by the foreign controlled firms in the country was found to be about seventeen per cent of gross savings and around twelve per cent of net savings. Thus, Canada's greater capacity to finance its own future growth does assume a large savings role by foreign controlled companies in Canada.

There are two major qualifications which must be added. The first has been mentioned previously, but merits repetition. The conclusions above relate to Canada's capacity to save the total amount needed for adequate capital investment. They say nothing about Canada's ability to generate some of the other inputs which often accompany foreign capital, such as technology, management skills and export outlets.

Secondly, they do not imply that Canada will not continue to rely heavily on foreign capital markets. Rather, they simply say that, in an aggregate sense, domestic savings should be sufficient or nearly sufficient to meet capital investment requirements at or near full employment. In practice, since there is a relatively free flow of capital into and out of the country, large amounts of Canadian savings are invested abroad and substantial proportions of foreign savings are invested here. This is a point which is dealt with more fully in the next chapter.

Chapter Seven

THE IMPACT OF CAPITAL MARKETS ON DOMESTIC CONTROL OF CANADIAN BUSINESS

INTRODUCTION

The effectiveness of the capital markets in mobilizing savings and the way in which they subsequently allocate those savings play an important part in determining the nature and structure of the economy, the level of industrial efficiency, the rate of economic growth and the degree of domestic control over the national economic environment.

The effectiveness of the markets in mobilizing savings plays a part in determining the total amount that is available for capital investment at any given time. The role played by the markets in allocating savings among the different sectors of the economy and the relative costs of acquiring different types of capital instruments—such as debt and equity—compared to the costs in other markets, all have a vital bearing on many facets of the economy's development. This chapter is concerned with examining the extent to which Canada's reliance on foreign capital of various kinds is affected by the performance of the capital markets and the extent to which lenders in Canada tend to give preference to foreign controlled firms.

As defined here, the capital markets include institutions which aggregate savings for their own account and then channel them to those requiring capital such as banks and loan companies. They also include institutions which help channel the savings of individuals and businesses without actually acquiring them, for example, securities dealers and the portfolio management activities of trust companies. Some institutions such as banks and trust companies, perform both jobs.

In a developed economy, where both lenders and borrowers are many and diverse, the process of matching needs of lenders and borrowers is a highly complex and specialized function. Those who provide the funds quite often prefer different terms and conditions than those who wish to use them. Savers frequently require short-term investments with a high degree of security, whereas borrowers normally prefer long-term financing. These varying preferences are supposed to be reconciled by the banks and other financial institutions. These intermediaries, in some cases, can also serve to pool risks and to provide ancillary services needed for entrepreneurial activity.

GAPS IN THE CAPITAL MARKETS

It was observed in Chapter Six that although Canada is not dependent to any significant degree on foreign savings in aggregate terms, there is a large two-way flow of capital into and out of Canada. In examining how the performance of the capital markets influences domestic control of the economic environment, the main issue considered is the extent to which Canadian savings are channelled into needed applications in Canada. More particularly, the analysis here is concerned with the extent to which Canada relies upon Canadian financial institutions to help finance new and generally more risky economic activity and the extent to which foreign sources finance these ventures. If Canada relies heavily on foreign sources, this would clearly reduce domestic capacity to control the economic environment. It would also likely reduce possibilities of increasing Canadian ownership.

Accordingly, this discussion focuses on the risk taking and entrepreneurial activities of Canadian financial institutions and on related factors, including the liquidity and capitalization of the capital markets and the degree of competition in the industry. The conclusion reached is that the markets show evidence of weaknesses and gaps in respect of risk taking and entrepreneurship. This chapter seeks to illustrate the nature of these gaps and weaknesses, to explain why they exist and to suggest possible courses of action to minimize them. In this context, it should be explained that one assumption underlying this discussion is that the general shortage of entrepreneurship in Canada can be partly overcome by entrepreneurial leadership from the financial institutions, rather than just the industrial sector alone.

The gaps and weaknesses are, broadly speaking, to be found in four places:

(i) venture capital for new and small firms;
(ii) expansion capital for small and medium-sized Canadian controlled firms;
(iii) large pools of capital for major resource exploitation and other capital intensive projects under Canadian control; and
(iv) capital for general development of regions of slow economic growth.

Other difficulties, for instance, in respect to the capital needs for housing and farming are outside the terms of reference of this study. In asserting that there are gaps, one point should be made clear. There is not necessarily a lack of funds available for filling each of the categories of needs outlined above. In some cases, there may be investors who are prepared to advance sufficient funds to meet a particular demand, but for one reason or another the process of bringing the borrower and the lender together is not carried out satisfactorily. This in itself is evidence of a weakness in the allocative function of the markets.

Secondly, the analysis also deals with the fact that lenders generally tend to give preference to foreign controlled firms. While this preference can undoubtedly be explained by the generally greater size and credit-worthiness

of foreign controlled firms, as opposed to those that are Canadian controlled, this remains a matter for concern in the context of assisting Canadian ownership.

The implications of these views are clear. The absence of a well-developed capacity in the financial industry to assist certain kinds of economic activity in Canada increases the likelihood of such activities being financed from abroad. The shortage of entrepreneurship in the financial industry frustrates the kind of industrial intermediation—the drawing together of financing and all the many other components to bring a new enterprise into being—which could permit a larger proportion of major projects to be undertaken in Canada by Canadians. The fact that normal risk aversion creates a lender's preference for the generally large foreign controlled firms (though not because they are foreign) reinforces these difficulties.

It is not reasonable to expect that Canada will be able to finance as high a proportion of very expensive major resource development projects (which can run to hundreds of millions and billions of dollars) as of the many smaller industrial kind (where needs can be as low as a few hundred thousand dollars). It is to be expected that some Canadian financing will be done in New York or other international financial centres. But the present heavy dependence on foreign financial institutions is greater than it need be for a country with a savings rate and industrial maturity of Canada's and this tends to draw direct foreign investment into Canada in situations where the economics of the project often do not require it, thus exacerbating the problem of domestic control.

Canada's heavy dependence on foreign capital markets at a time when the Canadian balance of payments is strong, and the payments position of the lending countries is relatively weak, poses an additional danger. In that kind of situation, there is always the possibility that the government of the foreign country in which Canadian users are raising money could restrict Canada's access to its capital markets. In that event, Canada would be obliged to fall back much more heavily on its own capital markets.

It must be emphasized that the discussion here deals only with a few aspects of the capital markets. It is generally accepted that important strides have been made in the development of a short-term money market in the last two decades (partly due to past governmental intervention), that the bond market is now absorbing more long-term issues than previously and, more generally, that non-financial firms are coming to rely progressively more on the financial institutions as a source of funds. Even with respect to risk taking, there have been improvements in the financial industry. For example, small and speculative firms (e.g., in computer software) have been able to receive underwriting support in the last several years, whereas it is doubtful that they could have received such assistance ten years ago. A venture capital industry appears also to be developing slowly. Finally, as explained previously,[17] much direct investment in Canada enters for reasons

[17] See Chapter Three.

unrelated to the performance of Canadian capital markets. Foreign capital often enters Canada when foreign entrepreneurs wish to increase the profitability of a distinctive product or technology by exploiting it in Canada or when they wish to obtain Canadian natural resources for supply assuredness.

In short, it is not suggested that the capital markets are seriously inadequate across the entire range of their activities or that their deficiencies account for all or most direct foreign investment. But it is argued that the capital markets are insufficiently competitive; that some of the institutions are undercapitalized; that some new institutions may be required; and that the markets ought to be more liquid. Hence, there are certain important market functions which are not being performed in Canada to the extent that is both needed and possible, and these functions must be performed in Canada if Canadians are gradually to take on more of the task of financing their own economic growth.

The discussion below sets out such information as is available on the capacity for risk taking and the degree of entrepreneurship in the capital markets. Some of the factors which are important for financial risk taking and entrepreneurship are examined to determine the reasons why capacity for risk taking is not greater. These include the liquidity of the capital markets, capitalization of financial institutions and the degree of competition in the industry. Each is therefore touched on briefly. Subsequently, there is a brief consideration of the role of Canadian financial institutions in regions of slow economic growth. The discussion then moves to the second theme of this section—the sources of finance available to foreign and Canadian controlled firms and the support that the Canadian capital markets afford to foreign controlled entrepreneurs.

The conclusions reached are based in part on the best available information. At the same time, it must be acknowledged that the information does not constitute firm evidence, due to the aggregate nature of the statistics. The aggregates tend to confirm that there are gaps, but they do not pinpoint them.

Discussions with those in the industry and a number of specific cases reinforce the view that gaps exist with respect to venture capital, expansion capital for small and medium-sized Canadian controlled firms and in the financing of large, capital intensive projects under Canadian control. It was also apparent from these discussions that many of the existing financial institutions do not consider it their function to fill these gaps or to provide the kind of entrepreneurship that is available in a number of other countries.

INTERNATIONAL INVESTMENT POSITION STATISTICS

Net capital formation constitutes net additions to the nation's capital stock; as such, it often (though not always) involves large pools of capital, or relatively high risk capital, or both. Statistics Canada has constructed a series showing direct foreign financing of net capital formation (including

investment in inventories). The direct foreign financing of net additions to capital stock is calculated to include gross direct investment inflows,[18] the retained earnings accruing to foreign direct investment already in Canada, new issues of Canadian securities (bonds, debenture and stocks)[19] acquired by non-residents plus other long-term investment and changes in accounts payable (which are related in part to inventory changes). These are taken as a proportion of net capital formation.

From these data, it is possible to construct a series on direct foreign financing of incorporated non-residential business in Canada. By excluding the financing of governments, government enterprises and residential housing, the series focuses on those kinds of investments which are generally riskier from the viewpoint of the investor. This series shows that from the mid-1950's through the mid-1960's, direct foreign financing of net capital formation for incorporated non-residential business averaged close to sixty per cent. At the same time, net use of all foreign resources as a proportion of net capital formation in the economy as a whole averaged less than 35 per cent. Great importance cannot be attached to the precise size of the gap of some 25 per cent due to statistical and conceptual problems. Nonetheless, these data do suggest that reliance upon foreign resources for net additions to the capital stock of the economy as a whole need not have been as great as the extent to which foreign capital did, in fact, participate in the financing of domestic capital formation.

During the 1965 to 1969 period, direct foreign financing dropped to around 41 per cent of net capital formation in the incorporated non-residential business sector. Net use of foreign resources as a proportion of net capital formation in this period fell to nineteen per cent, that is, the proportionate drop in direct foreign financing seems to have corresponded broadly with the increased domestic savings—rather than being related to the activities of the financial institutions.

These data are all highly aggregated. They are being used here for reasons which are not directly related to their original purposes and the comparisons are not conceptually pure. Notwithstanding these qualifications, they do tend to confirm broadly that the Canadian economy depends far more heavily upon non-resident sources of financing for expansion of the capital stock than is necessary for financial reasons. In particular, despite the fact that there are many other factors at play, these data suggest that the entrepreneurial and pooling capacities of the financial institutions are not sufficiently well developed for certain kinds of investment projects.

An effort was also made to see whether the Financial Flow Accounts published by Statistics Canada provided a further basis for assessing the role of Canadian financial institutions in supporting indigenous Canadian

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[18] Includes capital inflows for direct investment from countries other than U.S. on net basis only, i.e., after return of capital.

[19] It does not include net sales to non-residents of outstanding Canadian securities (bonds and stocks); however, some new issues sold to non-residents which might be used for re-financing of existing debt and not for new capital investment have not been excluded.

business. Owing to a variety of conceptual and statistical problems, this source did not prove very helpful. It is thus apparent that there is a need for improvement in the nature of the financial statistics available and that further research is needed in this area.

THE FINANCIAL INSTITUTIONS

To some significant degree, the fact that Canadian financial institutions have played a smaller role than would have been desirable in backing the establishment of new businesses and the expansion of older firms can be explained by the following considerations. Firstly, they were precluded from the opportunity to participate by foreign controlled businesses bringing their money with them. Secondly, much foreign direct investment was undertaken in response to non-financial factors and does not reflect gaps in Canadian capital markets (or for that matter to gaps in Canadian technology or management).[20] Furthermore, certain financial institutions, either by law or by their investment objectives, are effectively excluded from certain kinds of investments. No one expects a mortgage loan company to be in the venture capital business or pension funds to be in the business of making day-to-day loans. Legislation limits the investment choices of life insurance firms. Thus, it is not argued that foreign direct investment is entirely a reflection of gaps in financial institutions. But it is being suggested that the high level of foreign direct investment in Canada is in part attributable to the shortage of entrepreneurship and other weaknesses in the Canadian capital markets.

One way of looking at the situation is simply to consider the kinds of institutions and activities which one would expect to find in a developed entrepreneurial financial community. One would expect to find a large number of mature, competitive and well-capitalized merchant banks and other firms in the business of providing venture capital. One would also expect that some of the other financial institutions, with a wider range of activities—such as the chartered banks—would be vigorous and active in promoting and assisting new ventures and expansions of existing firms.

For smaller investments, the role of the venture capital firm or merchant banker might be to supply much or all of the capital. It would also involve the provision of related services and advice; and for the mechant bank particularly, it would include industrial intermediation.

For some of the much larger resource and hydro-electric projects, the merchant banker would perform a role similar to that expected to be undertaken in part by the Canada Development Corporation—supplying the entrepreneurship, helping to tie together all or part of the package of equity, debt, management services and markets needed to make the project go. Despite the adequacy of domestic savings, it is not expected

[20] See Chapter Two.

that Canada would be able to finance as high a proportion of these more massive projects as of the smaller ones because of institutional factors. But with greater Canadian entrepreneurial capacity, it should be possible for Canada to finance and control many more undertakings than it has in the past.

While such merchant banking services can be found in Canada, both in a handful of specialized institutions and within other more general financial institutions, such as banks and investment houses, they are not sufficiently developed. Canada's historical dependence upon foreign capital seems to have reduced the incentive for these kinds of institutions and financial activities to develop in Canada to the extent that they would have in the absence of foreign capital, simultaneously tending to perpetuate Canada's dependence upon foreign financial entrepreneurship.

Thus, there is a need for the establishment of new institutions or expansion of existing ones to provide more venture capital, expanded merchant banking services (either separately or as part of the venture capital industry), and possibly to focus on the development of some of the slower growth regions of the country. In addition, large pools of funds are required for resource exploitation. To meet all these needs, the financial community generally must be infused with a more entrepreneurial spirit. It is realistic to expect that the existing institutions might play a greater role. The banks have normally played a very small part in meeting needs of this kind. Some have created venture capital affiliates, or invested in venture capital firms which are apparently unaffiliated. But these investments are comparatively small. The securities dealers are too thinly capitalized to take on a heavy load of riskier issues. Other institutions which do have a better capital base —such as life insurance companies, pension funds and trust companies— are not now very active in this kind of business; a conservatism which may be partly traced to the experiences of the 1930's and the legal framework in which they operate.

The entrepreneurial gaps in the financial community are related to the environment in which they work. Various aspects of this environment are considered below, including: the liquidity of the capital markets; the volume of capital available in that part of the financial industry most likely to be playing an entrepreneurial role; attitudes toward risk taking; the limited degree of competition; and the relative indifference of the institutions to the regions of slow economic growth.

LIQUIDITY OF CAPITAL MARKETS

One of the factors which helps to determine the capacity of domestic capital markets to finance new issues and to engage in entrepreneurship is their overall degree of liquidity. This is a measure of the capacity of markets to absorb very large orders for the purchase or sale of a security without causing a significant change in its price, assuming that such large

transactions do not reflect any significant change in the underlying or total supply and demand conditions for the security. If an investor can be reasonably confident that he will be able to sell his investments without undue price penalty, then he is naturally more ready to assume risks. In general, in the case of the stock and bond markets, there is sufficient liquidity to provide this assurance to holders of small and medium-size blocks.

For the larger blocks of stocks, however, liquidity is not as great. Pension funds and mutual funds, for instance, claim that due to the thinness of the market they cannot buy and sell large blocks of stock on the Canadian stock exchanges without shaking the market price to their disadvantage. They point out that liquidity is also adversely affected by the absence of Canadian stock brokers prepared to buy and hold large blocks on their own account for brief periods during the transaction process. Brokerage costs in Canada are normally higher than in the United States partly because lower fees have not been charged on transactions of large blocks, as in the United States.[21] These are only some of the many factors which have led Canadian pension funds and mutual funds to invest heavily in United States stocks.

A number of other factors have also played a part in inducing large Canadian institutions to invest south of the border: shares in certain kinds of industries are not available on the Canadian market or are not available in sufficient numbers; securities regulation is more effective in the United States; more information is generally available on United States stocks, parents of multinational firms can provide a vehicle for investing in many countries. The net result of these factors is to reduce the total pool of capital available for the purchase of Canadian equities.

The large number of foreign controlled subsidiaries in Canada, which make little or no equity in their Canadian subsidiaries available to Canadians, also reduces potential investment opportunities in Canada. If such firms were required to issue shares to Canadians, it is possible that the large institutions would be less anxious to invest in the United States. With a larger pool of equity capital in Canada, this could result in more active trading and ultimately improve liquidity. However, in considering the desirability of requiring subsidiaries to make shares available to Canadian residents, account must also be taken of several other factors. This question is explored more fully in Part VI of the document. At the same time, it must be recognized that even in a better regulated securities industry, certain foreign stocks would remain attractive to Canadian investors and government policies alone (federal and provincial) would not likely stem the entire outflow of equity capital, short of formal quantitative limits or tax measures providing sufficiently strong counter incentives—or penalties.

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[21] Recent decisions by some of the stock exchanges to allow negotiated prices for very large blocks will ease this complaint somewhat. It is understood that changes in stock exchange rules may also allow Canadian brokers to hold large blocks during the transaction process.

Any change in the tax system which forced established firms to the capital markets for a greater proportion of their needs would also likely affect liquidity. The essence of such a change would be that a higher proportion of the money supply would be in the capital markets, money would turn over more rapidly and thus improve liquidity. Of course, any change of this kind goes to the heart of the tax system and would require a further separate study.

Greater liquidity in the stock market would also facilitate firms wishing to issue new stock or bond issues. That is, by making the markets more liquid, stocks would be more attractive. This would ultimately benefit the riskier new private and public issues and thus have a favourable impact on Canada's capacity to support new firms and new economic activity.

CAPITALIZATION OF THE FINANCIAL INDUSTRY

The capital resources available to the financial industry are one of the main determinants of its capacity to provide entrepreneurial support to business and to assist in risk taking. The parts of the financial industry of particular concern here are the securities and venture capital industries.

The Moore Committee Report examined the capital needs of the securities industry[22] and found it only slightly lacking in capital for carrying out the kinds of functions that the industry anticipated performing. However, the Committee also pointed out that the net worth of Merrill Lynch, one very large United States firm, was almost fifty per cent greater than the net worth of all Canadian controlled firms combined. While the worldwide assets of Merrill Lynch are obviously not at the complete disposal of its Canadian subsidiaries, they do provide an element of protection to the Canadian subsidiaries that is unavailable to Canadian controlled firms. The extent of the assets of a large firm like Merrill Lynch also illustrates that capitalization of the Canadian industry is not great, and this must inevitably affect its capacity to assume risk and to engage in additional entrepreneurial activity. The point here is not that the Canadian industry is necessarily reacting in a more conservative fashion to a particular risk, but that the risk itself is perceived differently because of much smaller capitalization.

Most corporations and many governments typically raise funds through the same dealer or group of dealers. For large issues, the dealers form a syndicate, in which the principal is the syndicate manager. Forming a syndicate permits wider distribution of the issue than the principal alone can market. It also reduces his risks. Smaller securities firms are often reluctant to challenge the bigger firms for the opportunity of managing

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[22] *Report of the Committee to Study the Requirements and Sources of Capital and the Implications of Non-Resident Capital for the Canadian Securities Industry, May, 1970.* The Committee was established by the Investment Dealers' Association of Canada and four Canadian stock exchanges.

the underwriting of the large issues for fear of losing all participation in future syndicates.

Even when an underwriter is large enough to handle a relatively small new issue, on his own, he may not do so lest other securities firms refuse to provide him with the necessary assistance in marketing large issues and lest they exclude him from participation in issues which they manage. With a better financed securities industry, firms would be better able to handle new issues or, at least, there would be the possibility of having genuinely competing syndicates, as is the case in the United States. This would tend to result in greater innovation and better service by the securities industry, lower prices for issues and ultimately a larger volume of financing.

A number of firms have grown up in recent years to provide venture capital, which is one aspect of merchant banking. In addition, there are also some private pools of funds. Although those in the industry insist that it is large enough to meet present requirements, in fact, it is tiny (worth perhaps about ninety million). One side of the venture capital business is that the firm must assume, at least in part, many of the functions of the enterprise which it is backing and this requires substantial capital and highly skilled professional staff. Money cannot be invested readily without careful and time consuming investigation. Hence a handful of such venture capital firms, as is the case today, is simply not enough for an economy the size of Canada's. With respect to industrial intermediation, there is little evidence of much such activity in Canada. To strengthen Canadian entrepreneurship and ownership, efforts should be made to develop the merchant banking industry.

Other parts of the financial industry—such as the banks, life insurance companies and trusteed pension funds—are much more heavily capitalized. Canadian banks have the size and financial capacity to assume heavy risks. However, their conservatism and normal risk aversion have led them to minimize their activities in these areas. This is also true of life insurance firms and pension funds. That is, the financial institutions with the financial capacity to be merchant bankers on a grand scale have chosen in the past to concentrate on other activities; as a result, they do not now have well-developed capacities to engage in such activities. But public policy could create incentives for them to do more of this in the future. Some possibilities are elaborated at the end of this section.

COMPETITION IN THE CAPITAL MARKETS

The amount of competition within an industry can be affected among other factors, both by the extent of its capitalization and by the degree of concentration within it. A well-capitalized industry is not necessarily a competitive one. But an under-capitalized industry, which is the situation

to be found in the securities and venture capital field, is likely to find it difficult to be very competitive. While a number of major financial institutions within the financial sector are well-capitalized, they also exhibit a high degree of concentration. The five largest chartered banks have 93 per cent of the assets of the chartered banking industry. In life insurance,[23] the 5 largest firms have around 63 per cent of the assets of that industry. The figures for trust, mortgage loan, sales finance, consumer loan and investment dealers are 61, 61, 68, 88 and 49 per cent respectively. In addition, there are some formal ties between these various kinds of institutions, other than between the bank; and non-banking deposit-taking institutions, re-enforcing concentration, e.g., between trust companies and mortgage loan companies. In the last set of revisions to the Bank Act, measures were taken to remove the links between banks and non-banking deposit-accepting institutions.

As already suggested, competition for underwritings is at best modest and it is difficult for new firms to challenge the established syndicate. From the perspective of the non-financial corporation wishing to float a new issue, it thus becomes very difficult to get competitive bids. To buck the system, a non-financial corporation has to convince one underwriter to compete for what has in the past been the business of another member of the syndicate. While this happens on occasion, it is not common.

At the same time, and perhaps more importantly, other financial institutions play only a peripheral role in backing unseasoned and riskier firms. The banks, life insurance companies and pension funds devote only a miniscule part of their resources to such investment. Through their recent participation in major resource projects, the chartered banks have given evidence of some willingness to assist. But their participation has been on a "last-in first-out" basis, thus enabling them to assume the minimum risk.

These comments are not necessarily criticisms of the existing institutions. Fort the most part, each does not consider itself to be in the kind of entrepreneurial business referred to here. Nonetheless, a need for such service exists.

Competition for new venture capital situations and new public stock issues is very limited. The securities dealers feel little pressure to play an important role in respect of the relatively unseasoned firms or to move into merchant banking. Indeed, the absence of vigorous competition within the securities industry, and from other parts of the financial sector, is such that most securities firms feel little need to protect their position by aggressively taking on new kinds of financing challenges. Also, the competitive environment probably has adverse implications for the price that users have to pay in raising money, which, in turn, affects their competitiveness.

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[23] Data reflect Canadian companies *only* (excluding participating and non-participating funds of Canadian companies). They exclude all British and foreign companies. Note that data for this group are as of December 1969.

The application of the proposed Competition Act to these industries, modified as it is to take account of the need for some degree of syndication (together with competition between syndicates), could be helpful in promoting a greater degree of competitiveness in this field.

Similarly, it is important that a part of the existing large pools of capital—in banks, life insurance firms, and pension funds—be drawn into more active support of such financing by participating directly or indirectly in such ventures (in some cases thus precluding the need for formal underwritings). That is, the distinctions between underwriting, merchant banking, and venture capital provision (which is part of the merchant banking function) do not require that institutions specialize in only one of these activities and that firms which are now in other business (e.g., banks) refrain from these activities entirely. Indeed, the opposite seems more important—that the barriers between the institutions be lowered and that competition between the various classes of institutions be increased even more than they have since the Report of the Porter Royal Commission on Banking and Finance.

In considering important changes, it must be recognized that the institutions have obligations to the depositors, policyholders and others, with the result that they could not be expected to engage in unbridled competition. Some regulation would remain necessary. Greater competition, within a framework of responsible regulation, might very occasionally create risks for financial firms (and their liability holders) but use of schemes analogous to deposit insurance would likely be a far cheaper way for the economy as a whole to take account of these dangers than results from the current level of competition.

REGIONAL FINANCIAL NEEDS

The discussion above dealt with liquidity, capitalization, attitudes and competition. The issue remaining is that of regional needs, because one legitimate concern about any foreign investment policy is that it may deprive the already capital-hungry, slow-growth regions of investment capital which they might otherwise receive.

Under the present system, the financial institutions are free, within the framework of Canadian law and regulation, to invest where their business judgment indicates that the best deals are to be made. They do not concentrate their assets in regions of slow economic growth because they believe good opportunities are proportionately fewer there. On the other hand, Canadian government priorities focus explicitly on these regions.

As matters now stand, the private financial institutions have no particular reason to share the government's concern about regions of slow growth. The question arises whether public policy should somehow seek to attract the private financial sector to help fill these needs, as the Regional Incentives Act does in respect of non-financial firms.

Linked to this issue is the question of whether a stimulus or incentive should be provided to encourage some Canadian financial institutions to acquire a stake in assisting the economies of the slow-growth regions by helping fill not only the capital demands of these regions, but also to seek out and to support indigenous entrepreneurial undertakings in these areas.

Only an institution whose profits and ultimate success lie in such a region might be willing to undertake this kind of activity. The issue which must be considered, therefore, is whether the government should help to create regionally based financial institutions which will have a stake in regional development and which can promote it without adversely affecting the simultaneous development of national capital markets able to serve the major requirements of all parts of the country. To achieve this reconciliation, the regionally based institutions would not only have to bring needed capital to that region, but also entrepreneurial skills to help to develop profitable situations, so that the flow of capital to the region would be based on sound resource allocation. This possibility is elaborated on in the conclusions of this chapter.

CANADIANS AS RISK TAKERS

While Canadian financial institutions do not now appear to be great risk takers, no evidence is available to suggest that individual Canadians are risk averters. Little sophisticated analysis has been completed in this field. Such evidence as is available, however, indicates that in relation to income level, Canadians tend to invest slightly more in dividend paying stocks than do Americans, except in the oldest age brackets, and that Canadians generally invest a larger proportion of their assets in stocks than do Americans.[24] (Because Americans generally have higher incomes than Canadians, they have a proportionately greater ability to invest in stocks.) It is not claimed that this is firm proof of the willingness of the individual Canadian to take risks, especially as no comparative evidence is yet available on the composition of portfolios, but only that there is no indication to the contrary. The point of these brief comments is to indicate why the conclusions and policy options outlined at the end of this chapter concentrate so heavily on the financial institutions, as opposed to private individuals investing for their own account.

THE FINANCING OF FOREIGN CONTROLLED BUSINESS AND ITS IMPACT ON CANADIAN CONTROLLED FIRMS

Related to the main concern of this chapter—the role of the capital markets in supporting indigenous Canadian economic development—is the role of the capital markets in supporting foreign controlled firms and the implications of this role for Canadian controlled firms.

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[24] G. R. Conway, *The Supply and Demand for Canadian Equities*, Toronto, 1970, pp. 69-71.

In general, statistical evidence available does not show any great differences between the financial structure of Canadian and foreign controlled firms. For example, there are no marked differences in ratio of current to non-current liabilities or in debt-equity ratios.

Some differences do exist, however. For instance, foreign controlled firms appear to place a proportionately greater reliance on short-term credit from parent firms than do Canadian controlled firms; and long-term advances from individual shareholders and affiliates, as might be expected, are much more significant as a percentage of non-current liabilities for foreign controlled firms than for those that are Canadian controlled. Thus, the financing needs of foreign controlled firms are eased by the fact that they have much larger foreign parents.

This does not mean that foreign controlled firms do not raise money in the Canadian capital markets. To the contrary, they have been making extensive use of Canadian bank loans and the Canadian bond and stock markets.

The Department of Industry, Trade and Commerce survey of 325 subsidiaries shows that between 1965 and 1969 the contribution of Canadian sources (such as banks and bond markets) to the annual growth in external finances of subsidiaries rose from 28 to 73 per cent, with a corresponding drop from foreign sources. By 1969, Canada was financing 35 per cent of the total liabilities of these subsidiaries, whereas Canadian sources had been providing only 28 per cent in 1964. While firm proof is not available, it seems likely that a part of the reduced use which United States subsidiaries have made of their United States sources as a reflection of attitudes created by the United States Balance of Payments Programme, even though technically it has not been directed against Canada.

Complete figures are not available about foreign controlled firms' use of Canadian capital markets. However, some indication is provided in the following information. Of the roughly \$9.6 billion in bank loans to businesses outstanding at the end of 1969, at least \$1.2 billion (12½ per cent) were provided to foreign subsidiaries covered in the Industry, Trade and Commerce survey. And since the sample of subsidiaries is not complete, the actual figure must have been a few points higher.

The Bank of Canada has provided data showing what proportion of net new issues of corporate Canadian dollar bonds and stocks were for corporations which were wholly or partly non-resident owned. The findings are summarized in Tables 16 and 17 below. They show that around 16 per cent of net new Canadian corporate bond issues and 23 per cent of the net new issues of corporate stock were for firms 50 per cent or more non-resident owned in the period from 1960 to 1970.

While these figures indicate that, in addition to their own internal financial resources, foreign controlled firms make significant use of external Canadian capital, this use is certainly not out of line with their importance to the economy. On the other hand, particularly in periods of tight money,

Table 16

NET NEW ISSUES OF CORPORATE CANADIAN DOLLAR BONDS
PERCENTAGE NON-RESIDENT OWNED

	Corporations 50% and Over		Corporations Under 50%		All Corporations
	$ Millions	%	$ Millions	%	$ Millions
1960	42.1	13.7	266.3	86.3	308.4
1961	−36.0	—	255.9	116.4	219.9
1962	−26.8	—	293.9	110.0	267.1
1963	77.8	18.8	335.9	81.2	413.7
1964	182.1	30.0	424.5	70.0	606.6
1965	116.5	12.3	831.0	87.7	947.5
1966	165.8	32.8	340.0	67.2	505.8
1967	120.2	15.9	634.1	84.1	754.3
1968	97.7	19.9	392.4	80.1	490.1
1969	71.6	13.3	465.6	86.7	537.2
1970	195.0	17.4	922.9	82.6	1,117.9
Total	1,006.0	16.3	5,162.5	83.6	6,168.5

Table 17

NET NEW ISSUES OF CORPORATE STOCKS IN CANADA
PERCENTAGE NON-RESIDENT OWNED

	Corporations 50% and Over		Corporations Under 50%		All Corporations
	$ Millions	%	$ Millions	%	$ Millions
1960	32.8	15.3	182.1	84.7	214.9
1961	119.1	50.3	117.5	49.7	236.6
1962	48.4	14.6	283.5	85.4	331.9
1963	85.6	—	−134.7	—	−49.1
1964	97.1	30.6	220.2	69.4	317.3
1965	110.7	23.7	356.9	76.3	467.6
1966	129.5	22.0	458.3	78.0	587.9
1967	119.1	26.5	330.1	73.5	449.2
1968	55.3	10.7	460.6	89.3	515.9
1969	110.5	14.1	675.0	85.9	785.5
1970	63.2	22.7	215.1	77.3	278.3
Total	971.3	23.5	3,164.6	76.5	4,136.0

it may be somewhat tougher for Canadian controlled firms to raise money than it would be if foreign controlled firms were not using the Canadian capital markets. While impossible to quantify, this has apparently been a sufficient concern that, in the past, the Governor of the Bank of Canada has requested the chartered banks to pay particular attention to loan applications from firms not having alternative sources of credit. He has also asked the banks to give priority to credit-worthy demands of Canadian customers, rather than to foreign subsidiaries, which could use the Canadian market to borrow on behalf of their parent firm—especially at times when Canadian rates fall below United States rates.

One question which arises from the data is whether foreign controlled firms should have continued access to Canadian capital markets. This answer must take into account the problems for Canadian controlled firms which arise during periods of tight money; the fact that Canadian balance of payments considerations may at times make it preferable for foreigners to borrow in Canada (as at present); and that foreign controlled firms do employ Canadian workers, directly and indirectly. In other words, their needs must be considered in the perspective Canadian economic interests. This policy issue is considered more fully later in this chapter and again towards the end of the study.

POSSIBLE MEANS OF IMPROVING CANADIAN CAPITAL MARKETS

Canadians seem to finance a smaller proportion of the growth in their productive capacity in the private sector in Canada than the volume of Canadian savings would permit as a result of many factors.

In the first place, a substantial proportion of the savings are generated by foreign controlled firms in Canada from their own internal cash flow.

Secondly, new firms enter Canada for reasons that are unrelated to Canadian capacities in financing, technology or management. For instance, the foreigner may find it profitable to exploit his product or different technology in Canada or to obtain Canadian natural resources for supply assuredness—and no barriers exist to his doing so.

Thirdly, foreigners take on projects which are judged to be too risky by Canadians. The foreigner's perception of the risk in many cases, however, is different than the Canadian's. The real risk is simply much smaller for the foreigner for one reason or another, perhaps because an export market is assured, a tax advantage is available from abroad, the investment constitutes a smaller part of his investment portfolio, he has greater experience in the business or his cost of money is cheaper.

The comparatively small role in support of risk taking and entrepreneurship played by Canadian financial institutions seems also to reflect several other influences. One is that the historical availability of foreign

direct investment has not been conducive to creating within Canada the kinds of institutions and persons able and willing to take on this role. The Canadian capital markets are not normally called upon to play a major role in launching major resource exploitation projects; and though they may occasionally supply much of the debt capital to the foreign firms, they do not now have a well-developed entrepreneurial capacity to play more than a limited financial role.

Furthermore, legislative and other constraints upon the investment choice open to the institutions tend to limit their capacity for filling some of the gaps. While intermediation does involve turning low risk short-term deposits into somewhat higher risk long-term investment, the institution cannot be insensitive to the nature and longevity of the savings it has accumulated. For instance, if the institutions are able only to attract demand money, their investment choices are limited. Some amendments to current legislation or practice might ease these restrictions, although wholesale change in this area has to be limited by the need for safeguarding the investments of private individuals and by the legitimate competing demands for capital, e.g., for housing or junior government financing.

At the same time, gaps do remain in the capital markets, particularly related to entrepreneurship, thus affecting perception of risk. These gaps are reinforced by the degree of liquidity, relative lack of capital available in the venture capital and securities industry—including merchant banking —in relation to the objectives for them proposed previously and the related absence of vigorous competition both within various sections of the financial industry and between sections.

To meet the concerns about the capital markets, certain policy options are considered below. A further very important consideration relates to the proposal of a screening process. To the extent that such a screening process is concerned with improving the returns which Canadians receive from foreign investment, it must have the capacity to bargain from a position of strength. This in turn means that it ought to have available to it an alternative Canadian capacity to do some of the things which the foreigners are willing to do. In the absence of a vigorous merchant banking or venture capital industry in Canada, and a generally greater degree of entrepreneurship in the financial community, the capacity to bargain effectively is reduced.

Some of the techniques which might be adopted in an effort to increase the capacity to undertake a greater proportion of high risk and entrepreneurial financing in Canada are outlined below. In proposing to increase this capacity, it should be emphasized that it is not intended that Canada should seek to undertake all those aspects of financing and industrial development which, because of international specialization, can at present be more efficiently performed abroad. The options put forward necessarily involve some expansion in the already major role played by the federal government in influencing the allocation of capital within Canada through

a variety of means. Its influence at present is exerted through tax policy, various methods of deficit financing, through transfer payments to provinces and individuals and its pattern of expenditures. The government plays a more direct role through particular public financial institutions, established to reduce in capital markets deficiencies that became evident in the past, such as Central Mortgage and Housing Corporation, the Industrial Development Bank and, more recently, the Canada Development Corporation. The government has also carried out its financing role through various grant and loan schemes, such as the General Adjustment Assistance Programme (GAAP), the Programme for Advancement of Industrial Technology (PAIT), the *Industrial Research and Development Incentives Act* (IRDIA), a number of regional economic development programmes, small business loans and a variety of farm assistance programmes.

LIQUIDITY, CAPITALIZATION AND COMPETITION

Any measures which can be taken to improve the liquidity of the stock market and the capital available to the more entrepreneurial parts of the financial industry should have a beneficial spill-over impact on the financing of new issues. Scope for a federal initiative is affected by existing provincial involvement in this area. With or without a greater federal presence, any assistance or support which can be given to proposals to increase liquidity should be considered carefully. This would include providing for better disclosure of corporate situations and developing an effective national system of securities regulation.

One possible option that might be contemplated under certain circumstances is that of allowing or even encouraging a particular type or types of foreign financial institutions to establish in Canada. Because some foreign financial institutions tend to have more capital than their Canadian counterparts, they could conceivably bring benefits to the market in the form of improved liquidity and competition. Against such benefits would have to be weighed the possible disadvantage that foreign financial institutions might distort the allocation of savings, perhaps by encouraging Canadians to invest abroad or by giving foreigners a preference in investing in attractive Canadian ventures. Such concerns might be overcome or minimized by requiring as a condition of their entry that foreign financial institutions allocate their funds according to the broad pattern laid down by federal authorities, possibly through the instrument of a review agency. While there might be some increase in the degree of foreign control of some areas of the financial industry as a result of following this course, it could serve to play a part in reducing the extent of foreign control in the non-financial sector of the economy.

In addition to the benefits that may be derived from the application of the proposed Competition Act to most of the classes of institutions in the financial sector, it may be desirable to consider whether further benefits

should be sought by extending the restructuring of those industries that was undertaken through legislation enacted within the past five years. In part, this could involve the adoption of measures aimed at further reducing the compartmentalization of financial institutions as another means of increasing competition.

Consideration might also be given to the possibility of providing incentives to encourage existing financial institutions to achieve greater entrepreneurship, to the development of additional pools of capital—either through new or existing institutions—and to a further expansion of the financing role undertaken by the federal government. Measures of this kind could serve to strengthen competition in the financial sector and to reduce the gaps that now exist in the financing of Canadian controlled business.

Before outlining some of the considerations involved in each of these possible approaches of a general nature, attention is focused on a particular problem, that of meeting the financial needs of the slow growth regions.

REGIONAL NEEDS

The general lack of entrepreneurial thrust in the financial industry seems to be a particular problem in the regions of slower economic growth.

As one way of dealing with this problem, consideration might be given to the creation of regional financial institutions, such as regionally based banks. Although real administrative problems undoubtedly would exist, one possibility might be a bank free to raise deposits anywhere in the country but required by statute to invest a proportion of its assets in a designated region. Depositors would presumably be reassured by existing deposit insurance. Such a bank would only be able to accept deposits and to grow to the extent that it was able to invest profitably in the designated region. This, in turn, would require it to help to create attractive investment opportunities for itself in that region—that it play the role of entrepreneur.

A second possibility open for consideration would involve revisions to the Bank Act to allow provincial governments to participate financially in the establishment of a federally chartered bank. Such an amendment might allow the province to subscribe to 25 or 50 per cent of the initial capital, but with a provision that it sell its shares to the public over a period of years.

Both possibilities would require further consideration by the government.

POSSIBLE INCENTIVES AND INDUCEMENTS

As already mentioned, three other types of action might also be considered. One is to try to create incentives and inducements to get the existing institutions to expand their role in financing new capital stock. Another is to encourage, both directly and indirectly, the creation of new

institutions specifically aimed at filling existing gaps. Finally, new government sources of capital could be mobilized. Some of the possible ways of achieving these ends are touched on below to illustrate the kinds of ideas which might be explored more fully. While not advocating any particular one of these possible policy elements, it appears evident that some measures in this area should be examined to further assist entrepreneurship and generally to encourage more competition and innovation in the capital markets.

Looking firstly at the kinds of inducements and incentives which can be used to make capital allocation more responsive to the gaps in the financial markets, the main issue is how to get the existing large pools of capital to play a greater role, i.e., the banks, trusteed pension funds and life insurance companies.

One way of doing this might be through encouraging the grouping of individual pension funds and life insurance companies into syndicates for investment purposes. These institutions are properly concerned with fulfilling their obligations to pension and policyholders. At the same time, it is possible that the large sums of money they dispose of could be used to fill at least a portion of the capital needs for resource exploitation. Admittedly, the individual pension fund might be running an undue risk in placing a significant proportion of its assets into a new manufacturing venture or resource project. But consortia of these institutions jointly investing five or ten per cent of their assets in higher risk new economic activity should be feasible, as the large sums would allow sufficient diversity to spread the risks and finance much of what is now being financed from the United States. What would be too risky for one institution could be good business and highly profitable for a group acting in concert. This could be done, of course, by subscribing to new issues underwritten by the securities industry. It could also be done through these consortia, in effect, acting as underwriters. Again, very careful study of the techniques needed, as well as the feasibility of such an approach, would be required.

At present, life insurance companies may be discouraged from investing in equity capital because of certain provisions in federal law (for example, regulations covering the valuation of their liabilities) which make it possible for a firm to be technically insolvent in a stock market downturn. Another technical difficulty for companies is how to reflect capital gains in the book value of their assets. These problems should be studied to determine whether greater investment scope could not be given to these firms without in any way endangering the position of policyholders. This should include a re-examination of the notion of life insurance firms being in technical bankruptcy, since this seems to be largely a book-keeping concept with only limited relevance to their real financial position in at least some circumstances.

Thirdly, the Bank Act could be reviewed to consider whether the existing statutory limits (Section 76) on equity investments by banks in other industries are an unnecessary limitation on their capacity to engage in

greater risk taking and entrepreneurships. In so doing, it must also be recognized that reducing these restrictions opens up the possibility that the banks could acquire control of substantial parts of non-banking industries, depending on the extent they were permitted to go beyond present limits in acquiring equity.

NEW INSTITUTIONS—MERCHANT BANKS

The above proposals relate to the creation of incentives to encourage the existing institutions to behave somewhat differently. In addition, it is apparent that certain kinds of institutions are lacking on the Canadian scene. In particular, merchant banking has yet to develop beyond its infancy in Canada. While the Canada Development Corporation may go some way toward filling this gap, it is believed that still more development is required in this area so that the matching up of buyer and seller and of entrepreneur, inventor and financier are all encouraged. The possibility of creating some form of inducement to encourage such activity in Canada should be investigated.

DIRECT GOVERNMENT ROLE

Any of the possible measures outlined above involving the private financial sector would help to create a better environment for more entrepreneurship and risk taking in the capital markets. Because it could take considerable time for the private sector to fill these gaps, it may be desirable for the government to adopt an expanded role. While the Canada Development Corporation, recently established by Parliament, can play a very useful part, certain financial needs will remain unfilled—particularly those for venture capital and expansion financing.

With regard to venture capital, it is suggested that the legislation respecting the Industrial Development Bank might be re-examined with a view to considering whether this institution should play a greater role in the financing of small Canadian controlled firms. This might not only involve a close look at the way in which the current law enables it to handle venture capital situations, it could also involve authorizing the IDB to actively seek out venture capital situations. This latter possibility would impose a substantial responsibility on the IDB.

Even if the IDB were to fill a part of the gap at the venture capital end of the spectrum, while the CDC takes steps to fill the gap at the other end by providing funds for very large undertakings, there would still remain a void which the federal government could help to fill. This involves the provision of expansion capital to medium-sized Canadian firms with requirements ranging roughly from $500,000 to $15 million.

What might be valuable here is an expanded General Adjustment Assistance Programme based largely on insured loans, but with the capacity

to lend or acquire equity directly. The right to hold equity would be particularly important in situations where regular interest payments placed an undue burden on the firm starting out. Such a programme would be restricted to Canadian controlled firms and might either be aligned with the IDB or run on an entirely separate basis. In considering various alternative possibilities for expansion of the government's financing role, care must be taken to prevent enterprises in the private sector from becoming unduly dependent on the government to assume a substantial proportion of the risk before they will be prepared to launch a new venture.

ACCESS OF FOREIGN CONTROLLED FIRMS TO CANADIAN MARKETS

Balance of payments considerations may create a bias in favour of or against allowing foreign controlled firms access to Canadian capital markets at any point in time. A further consideration that arises is whether encouraging foreign subsidiaries to finance in Canada would not improve liquidity in capital markets generally. Nevertheless, there remains a continuing concern about how financing in Canada by foreign subsidiaries affects the access of Canadian controlled firms to the capital markets. Indeed, to the extent that other measures may be successful in encouraging greater financial entrepreneurship in Canada, it is important to ensure that such improved performance does not redound to the benefit of foreign controlled firms only. While funds loaned to foreign controlled firms do recirculate and may again become available, the net impact of lending to foreign controlled firms is likely to involve some reallocation of funds that would otherwise be available to Canadian controlled users.

This suggests one argument that can be made in favour of requiring foreign controlled firms to obtain government approval for all substantial new Canadian denominated stock or bond issues and substantial increases in bank credits or loans. The considerations which could be used in determining whether approval would be given include balance of payments factors, the adequacy of funds available for Canadian users, the economic merits of the investment for which funds were being solicited, the danger that reduced demand on Canadian capital markets would weaken their capacity and whether foreign participation is required to make the project viable. Alternatively, new stock and bond issues alone could be subject to government scrutiny. This would raise fewer problems, though clearly there would remain much opposition to such an approach.

The approach outlined above is based on the view that foreign controlled firms frequently appear able to raise money from their parents abroad and would not be seriously damaged by some review of their access to Canadian capital. It also reflects a concern about the access of Canadian controlled firms to expansion capital. At the same time, however, it would also provide a vehicle through which the government could review certain aspects of the foreign controlled sector if it wished to do so.

CONCLUSIONS

To summarize, there are no strong reasons, relating to the Canadian balance of payments or to the volume of domestically generated savings, which would require Canada to rely upon foreign direct investment to maintain a satisfactory rate of economic growth. The main worry is that Canadian savings are not being transmitted by the financial intermediaries to business enterprises for the starting up and expansion of capital stock to the extent that the level of savings in the economy would permit.

As the adequacy of domestic savings has improved, the volume of savings directed by the intermediaries for investment in manufacturing and resources has increased.

Given that the balance of payments and the volume of domestically generated savings are such that there is no great need for foreign direct investment, the above chapter focused on the need to make Canadian capital markets more responsive to the need for more investment capital. At the same time, it was recognized that foreign direct investment might well be desirable when it brought with it certain other economically valuable characteristics, such as technology, management, entrepreneurship and export markets. These characteristics are examined in following chapters.

Chapter Eight

THE TECHNOLOGICAL IMPACT OF DIRECT FOREIGN INVESTMENT

INTRODUCTION

One of the main determinants of economic growth is the rate of improvement in the productivity of the factors of production. Among the most important influences affecting productivity are advancements in technology.

Historically, Canada has been very heavily dependent upon foreign technology. Foreign technology has entered through the importation of finished products, through direct investment and by licensing agreements between Canadian firms and foreign owners of technology. The focus of this chapter is upon the technological impact which direct foreign investment has on Canada and on the benefits and costs of the technology which arrives in the direct investment package. Account is also taken of alternative methods (other than direct investment) of obtaining new technology.

The benefits of foreign technology are in most cases apparent and readily identifiable. Most Canadian economic activity relies upon advancements in science and technology discovered and developed elsewhere in the world. Many of these developments, particularly the older ones, are in the public domain and are freely available to all of mankind to draw upon.

But many of the recent advances are not, of course, available free of charge. They are, in effect, private property and often foreign owned. In other cases, even if not legally owned by a foreigner, the foreigner alone understands the complicated technical "know-how". The prospect of living without many of these recent advances involves a cost which most Canadians would not tolerate. To obtain access to that portion of technology which is owned by foreigners, Canada pays a price. This price falls into several different categories:

(i) Canadian subsidiaries using the technology of their parents pay fees or royalties for the right to exploit it in Canada or are made to pay in some other way (e.g., by being required to purchase other goods or services from the parent). Canadian firms which obtain

foreign patented technology or "know-how" under licence on an arm's-length basis also pay royalties. If technology is imported in the form of finished products, Canada pays for the technology in the price of the finished goods.

(ii) Conditions are often attached to the foreign technology which Canadian firms obtain, be it on an inter-affiliate or arm's-length basis, which limits the export markets for which it may be commercially developed in Canada. These limitations must be weighed against any benefits gained by Canada through decisions by the parent to protect its Canadian subsidiary or licencee against competition from itself or other affiliates or licencees. These restrictions have an important bearing upon the Canadian industrial structure and the competitive position of Canadian industry.

(iii) The ready availability of foreign technology can frustrate Canadian technological development and the strong technological infrastructure which is needed, not only for further technological development but for buying foreign technology cheaply and wisely. The ability to obtain technology abroad at the most reasonable possible cost and to apply it in Canada as effectively as possible is perhaps even more important than domestic technological development.

Past public policy has recognized the importance of science and technology to mankind. The Canadian government has a long history of substantial expenditure in Canadian government and university laboratories. While aimed partly at improving our knowledge both of the world and of the Canadian environment, it has also been based in part on the related expectation that the emergence of a strong scientific community in Canada would have an important spill-over impact upon Canada's industrial capability. More recently, both through tax and grant incentives, the government has explicitly encouraged expenditures on research and development in private business. Notwithstanding these measures, the record of indigenous technological commercial output has remained poor and Canada's dependence upon the outside world has, in fact, been increasing.

It was implied above that the importation of technology through direct investment results in both costs and benefits to Canada. In general, as stated, the benefits have been such that Canada could not have realistically lived without them. But this does not mean that the imported technology has necessarily entered Canada in the best form. In some cases it might have been more efficient to import it in the form of a final product or to buy it on licence. Nor does it mean that the price which has been paid has been a fair one for Canada. In other words, the main question at issue is not whether, on the whole, the benefits of access to foreign technology outweigh the costs, but whether, in particular cases, direct investment is the best form for Canada to obtain the foreign technology and whether the price being paid is a reasonable one.

THE IMPORTANCE OF TECHNOLOGY

Technological advance has its impact on the economy through improving productivity, that is by increasing the output obtained from any fixed amount of input. The technological superiority of a particular industry or an economy generally makes possible the export of goods or investment which embody these advances.

Quantitative measurement of the relative importance of technology in advancing productivity, trade and investment is difficult. In each case, there is a wide range of other factors which also influence the rate of advance. The concept of "productivity" is itself difficult to measure.

It is through its impact on productivity that technological advance affects the overall performance of the economy and Gross National Product. Increases in Gross National Product can be caused by various factors—the greater realization of economies of scale, improvements in the quality of the inputs of production, fuller utilization of productive capacity, improved educational levels of the work force, greater efficiency resulting from shorter hours of work, and an inter-industry shift of activities to more productive fields. Although, as stated, the portion of GNP growth attributable to the advancement of technology is not easily measured, estimates are that for the United States economy technological development accounts for around forty per cent of the increase. For the Canadian economy, an estimate of thirty per cent has been suggested as more accurate. Education is credited with a comparable contribution in the Canadian economy, although education does, to some extent, involve the more complete distribution and effective use of existing knowledge of technology and systems. Thus, technology is credited with the largest single contribution to economic growth.

The impact of technology on society does not lie solely in economic expansion and enhanced productivity. The cultural and social effects and the relevance of technology for other attributes of the "quality of life" must be considered in any complete appraisal. These are examined more fully elsewhere in this study.[25]

The maximum social gain from technology comes when its potential is fully exploited: when it is available to all possible users in a variety of industries or applications; when it is embodied in the goods of several producers so that its benefits can be made available to as many users or consumers as possible at the lowest cost possible; when it is publicly available, for further development to take place based on the knowledge and capacities which it represents.

A market economy relies to a considerable extent on private interests to undertake the expenditures involved in the production of new technology. Public policy supports this process by patent protection, which permits the

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[25] See Chapter Seventeen.

innovator to anticipate a profit and thus encourages him to spend on research and development.[26]

Foreign technology, however, is in some cases a "free" good. That is, it may have been developed for other markets. To grant it this form of protection in Canada—or as much protection—may be neither necessary nor desirable. Public policy should aim for the maximum rate of dissemination of technical knowledge—subject to sufficient incentive remaining to encourage that necessary level of research expenditure to maintain a suitable rate of innovation. The question arises whether Canadian patent law and administration go well beyond the degree of incentive which is required.

CANADA'S DEPENDENCE ON EXTERNAL TECHNOLOGY

Several different yardsticks have been employed to measure Canada's dependence on technology from abroad. While no single one is perfect, they all show much the same pattern.

The first measurement is based on patent statistics. While all forms of technology are not patented, patent statistics are often used as a proxy for technological output. Some 95 per cent of patents issued in Canada are registered to foreign owners, of which two-thirds are owned by United States residents.[27] This is one indicator of Canada's dependence on external technology.[28]

Another study shows that in a list of 25 countries, Canada is first in percentage of patents which are foreign owned and last in the percentage of patents owned by nationals of the issuing country.[29]

Table 18 below shows the results of an OECD study. It is based on four performance indicators of technological innovation in ten industrially advanced countries. By one criterion, namely, monetary receipts for patents, Canada ranked eighth among the ten countries. In three others, Canada ranked ninth or tenth. The criterion of greatest commercial importance, perhaps, is that showing Canada ninth in export performance in research intensive product groups. In the composite ranking, Canada had the worst performance of the ten countries.[30]

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[26] Public funds and tax incentives are also allocated to support this kind of activity, as the public benefits often tend to exceed the private benefits from such research. Governments generally protect private proprietary rights even when they have been publicly financed.

[27] Patent protection is used in Canada quite widely in comparison to other countries, thus the low level of patent ownership by Canadians does not reflect relative absence of reliance on patents as a form of protection. The source for the statistics is the Annual Report of the Patent and Copyright Office.

[28] Some technological breakthroughs developed in Canada may register in the name of foreign parent firms. Thus 95 per cent may be a slight exaggeration of reliance on external technology.

[29] Based on research for the Economic Council of Canada.

[30] While Japan does not appear in too favourable a light, it should be noted that Japan has relied on importing technology and producing with the imported technology more cheaply than other countries. It should also be noted that the figures for three of the criteria apply to years between 1963 and 1965.

TABLE 18

FOUR PERFORMANCE INDICATORS OF TECHNOLOGICAL INNOVATION IN TEN INDUSTRIALLY ADVANCED COUNTRIES*

Indicators	Number of Industrial Em-ployees	I. Location of 100 Significant Innovations since 1945			II. Monetary Receipts for Patents etc., 1963–64			Percent Share of 10 Coun-tries' Mfd. Exports	III. Number of Patents Taken Out in Foreign Countries, 1963			IV. Export Performance in Research-Intensive Product Groups 1963–65			Com-posite Rank
Country	('000)	Abso-lute No.	With USA Base 100	Rank	Abso-lute $ million	With USA Base 100	Rank		Abso-lute No. (000's)	With USA Base 100	Rank	% Share of 10 Coun-tries	With USA Base 100	Rank	
Belgium	1,645	1	20.6	5	7.9	34.2	5	5.8	1.8	12.4	10	3.0	37.6	10	8
Canada	2,428	0	0	10	6.2	18.3	8	5.5	1.9	13.9	9	2.0	38.3	9	10
France	7,940	2	8.5	8	46.3	41.9	4	9.8	9.3	38.1	6	6.5	48.2	8	6
Germany	12,385	14	38.3	4	49.4	28.7	7	18.1	29.9	64.7	2	21.1	84.7	2	3
Italy	7,776	3	13.2	7	9.9	9.1	9	7.5	4.6	24.6	7	5.7	55.2	6	7
Japan	17,129	4	7.9	9	5.9	2.4	10	8.1	3.5	17.4	8	5.9	52.9	7	9
Netherlands	1,847	1	18.3	6	26.0	101.2	1	5.9	6.4	43.6	5	5.9	72.7	5	5
Sweden	1,535	4	88.4	2	7.1	33.3	6	3.5	3.8	43.7	4	4.0	83.1	3	3
U.K.	11,798	18	51.8	3	76.1	46.4	3	13.2	15.2	45.2	3	13.9	76.5	4	2
U.S.A.	25,063	74	100.0	1	386.7	100.0	2	22.6	56.3	100.0	1	31.1	100.0	1	1

*SOURCE: OECD Document SP(7) 1, Table A.1.

NOTE: For indicators I and II the ranking was derived by dividing the absolute values by the number of industrial employees to correct for country size. For indicators III and IV the ranking was derived by dividing the absolute values by the percentage share of the ten countries' manufactured exports.

The table suggests that Canada's technological output, compared to that of other industrial countries, has been very low. On the other hand, the table does not suggest any correlation between technological output and rate of economic growth. For instance, Japan's composite rank is ninth and yet it has enjoyed a rate of economic expansion which has been the envy of most western countries. In contrast, despite its very high composite rank, the United Kingdom has grown less rapidly than most other countries listed in the above table. Bearing in mind the importance of technology to economic growth, the above data suggest that the essential need for economic development is not necessarily extensive indigenous technological output, but rather a capacity to use technology effectively, whether it is domestic or imported.

It is by no means self-evident, therefore, that Canada should simply be devoting greater effort to improving its technological output. Before reaching such a conclusion, it would be necessary to conclude that Canada could obtain its inputs more cheaply by developing them at home than by buying them abroad, or that indigenous development would provide greater benefits for the Canadian industrial structure. This is an issue which will be considered later.

REASONS FOR CANADA'S COMPARATIVELY LOW LEVEL OF TECHNOLOGICAL OUTPUT

To understand why Canada's technological output has been so low in comparison to other countries, it is necessary to take account of Canadian *input* into research and development activity and of the factors which help to influence it in comparison to inputs of other countries. Some of these include:

—the relative size of foreign (particularly United States) and Canadian economies, their characteristics and the general economic environment in both countries;

—the heavy degree of foreign control in Canada's technologically intensive industries and the related fact that parent firms in these industries normally tend to centralize research efforts at home;

—the heavy concentration of Canada's research activity outside of the business sector.

Each of these points is examined further below.

THE RELATIVE SIZE OF CANADIAN AND FOREIGN ECONOMIES, THEIR CHARACTERISTICS AND THEIR GENERAL ECONOMIC ENVIRONMENTS

Ready access to a large market helps determine the incentive of a firm both to allocate resources for original research development and innovation and to purchase and adopt existing available technology. Firms with duty-free access to very large markets (either at home or through participation

in a customs union or free trade area), such as the United States, have such inducements. Canadian firms are somewhat at a disadvantage in this respect, as they generally lack duty-free access to very large markets.

This is not to suggest that the Canadian market is too small to support an optimally efficient plant or firm using the most up-to-date technology in many industries, although it is likely too small in several industries—such as aircraft and some chemicals. But the fragmentation of the Canadian market between several firms in many industries does mean that the risks are normally much greater than for a United States or EEC based firm; and even when the Canadian market is large enough to support efficient production, the incentive to innovate is less than in much larger markets, because the profits which can be anticipated are often smaller unless the Canadian firm can somehow be sure of access to large markets.

Size of firm can also be an important determinant of a firm's capacity to spend meaningful amounts on research and development. Large Canadian firms in some industries are not too small to afford the minimal R&D expenditure level which is required for the efficient use of funds. But the cost factor undoubtedly does deter some Canadian firms, either because in some industries the research expenditures involved are too great by themselves or together with associated development and marketing costs, or because concentrating research expenditures in a narrow range of activities is too risky.

In addition to the above factors, as indicated earlier in this report,[31] the characteristics and general economic environment of a country also have an important bearing on the creation of an atmosphere conducive to innovation. The level of per capita income, the rate of growth of income and its impact on consumer tastes, the costs of labour—which induce recourse to labour-saving technology in production, management capacities and attitudes, all support innovative efforts. A highly competitive environment has the same effect, driving individual firms to innovate to get and stay ahead. These are factors found first and foremost in the United States. In recent years they have been found more and more frequently in the European Economic Community and some are beginning to emerge in Japan. With Canada's comparatively smaller market, less competitive environment, and lower managerial capacities than in the United States, innovative pressure is less prevalent in this country.

THE HIGH DEGREE OF FOREIGN CONTROL IN CANADA'S TECHNOLOGICALLY INTENSIVE INDUSTRIES

Table 19 shows those industries in Canada and the United States that are the most research intensive. It will be noted that among the United States industries listed, transportation equipment, electrical products, chemi-

[31] See Chapter Three.

cals and machinery are the ones in which R & D expenditures are highest. It will also be observed that the table excludes entirely the many industries with a lower research input, such as clothing, textiles, furniture and wood.

TABLE 19

R & D EXPENDITURES IN SELECTED CANADIAN AND U.S. INDUSTRIES PER $1000 SALES*

	Canada	U.S.
	$	$
Chemicals and Allied Products	18	26
Petroleum and Coal	11	14
Rubber and Plastic Products	6	11
Non-Metallic Minerals	3	8
Primary Metals	7	4
Metal Fabricating	2	4
Machinery	7	21
Electrical Products	36	63
Transportation Equipment	9	63

*DBS, *1967 Annual Census of Manufacturers, Preliminary Bulletin,* No. 31-208P. Table 2, pages 3 and 4. Value of Shipments of goods of own manufacture has been used as a proxy for sales. DBS, *Industrial Research and Development Expenditures in Canada, 1967,* No. 13-532. Table 4, page 31. United States Department of Commerce, Bureau of the Census, *Statistical Abstract of the United States, 1969.* Table 1109, pages 716 to 721. Value of Shipments has been used as a proxy for sales. N.S.F. *Research and Development in Industry, 1967,* No. 69-28. Table 22, page 4.

As suggested above, the large size and the nature of the United States market has made it possible for United States firms to spend the large sums needed to develop advanced and, in some cases, unique capabilities in these technologically advanced industries (i.e., transportation equipment, electrical products, chemicals, machinery and instruments). Having developed these distinctive capabilities, they have been able to exploit them in world markets. One measurement of the importance of these industries in the international economy is that they account for 72 per cent of United States exports, but only 39 per cent of United States sales. This advantage is exploited not only through the export of goods, but also through the export of direct investment capital. This is reflected in the high degree of United States control of Canadian business in many of these same industries.[32]

In general, multinational firms prefer to concentrate their research activity in their home base. Thus, as Table 19 above tends to suggest, Canadian subsidiaries in technologically intensive industries are generally not given the opportunity to do proportionately nearly as much research as their parent. Moreover, some of the R & D undertaken in Canada un-

[32] See Chapter Four.

doubtedly reflects efforts to modify technology developed abroad to specific Canadian needs. And some of it reflects situations where there are significant cost advantages in undertaking R & D in Canada (including the cost advantage of tax incentives and public funds), which is not offset by any disadvantage of decentralizing of research and development efforts. However, even when a portion of the research of a multinational firm is located in Canada, it is coordinated with the research of the entire international organization, directed from the home base, and thus not necessarily fitted into the productive activity of the Canadian subsidiary.

More detailed evidence tends in fact to confirm that the subsidiary normally undertakes significantly less research than the parent. One study undertaken in 1959 reported that as a percentage of sales, 72 per cent of the subsidiaries survey spent less on R & D than the parent, 23 per cent spent about the same amount and 5 per cent spent more.[33] Where the product line manufactured by the parent and the subsidiary was the same, only 25 per cent did any research at all. Where the product line was different, 68 per cent undertook research efforts.[34] Unfortunately, these data do not take account of the useable developments which flow from the expenditure inputs or whether discoveries in the laboratories of Canadian subsidiaries are exploited commercially in Canada or elsewhere.

The same study, using 1959 data, also showed that foreign controlled firms spent about the same on research and development as their Canadian counterparts in the same industry. The study was based on "matched pairs" (i.e., Canadian and foreign controlled firms of similar size in the same product line) and compared their financial inputs. For many foreign controlled industries, unfortunately, no Canadian match was available.

In the last few years, Canadian controlled firms have spent much more in both absolute and relative terms than they did a few years ago. In contrast, actual expenditures of foreign controlled firms seem to have peaked and they actually fell in 1970, while their relative share has also declined. In 1970, Canadian controlled firms spent more than 45 per cent of the total, compared to 39 per cent in 1967. In view of the fact that around 90 per cent of total R & D expenditure is in manufacturing industries, that Canadian controlled firms constitute less than 45 per cent of the manufacturing sector and that they are concentrated in the less research intensive industries, it would appear that the R & D effort by Canadian controlled firms has recently compared more favourably with the foreign controlled sector than previously, as indicated by the figures in Table 20. It is too soon, however, to be sure exactly why these changes have occurred and whether they indicate anything more than a temporary cyclical change.

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[33] A. E. Safarian, *Foreign Ownership of Canadian Industry*, Chapter VI. Note that the data are for the year 1959, prior to the introduction of some of the more generous government incentives for research.

[34] See remarks on "costs" later in this chapter.

Table 20

INTRAMURAL R & D CURRENT EXPENDITURES
BY CANADIAN INDUSTRY 1965–1970*

$ one in millions

Expenditures by:	1965	1966	1967		1968		1969		1970	
	$	$	$	%	$	%	$	%	$	%
Canadian controlled....	n.a.	n.a.	113.8	39	120.3	39	142.2	42	154.0	45
Foreign controlled......	n.a.	n.a.	176.8	61	184.8	61	198.5	58	184.4	55
	236.8	266.4	290.6	100	305.1	100	340.7	100	338.4	100

*Source: DBS.

Once foreign investors have located in Canada, they have fairly easy access to technology developed here, to governmental support for R & D activity and to skilled Canadian research personnel. These firms have the ability to exploit these features and to export the resulting capacities to the parent or affiliates. At the extreme, the export of skilled scientists brings no return to Canada, despite an investment in their development, unlike the export of technology under licence or of goods manufactured in Canada. In fact, foreign controlled firms do draw much more on governmental contracts and grants than Canadian controlled firms (although the latter are now absorbing the greater proportion of PAIT and IRDIA funds). Despite this, there has been the decline already noted in R & D expenditures by foreign controlled firms.

In addition to domestic expenditures on research and development, Canada spends money on imported technology. The importing is done both by subsidiaries and on an arm's-length basis. A certain proportion of these imports are formally recorded as imported services and reported as such to Statistics Canada. For 1969, the statistics show that firms covered in its survey paid $63.5 million to persons outside of Canada for patents and technical know-how (the reported trade deficit in technology was $42.2 million).[35]

The actual value of imported technology is undoubtedly much higher, however, in that Canadian subsidiaries doubtless obtain much foreign technology from their affiliates abroad, without formally paying for it as technology. Payments, for instance, might be categorized under management fees or reflected in the price at which goods between parent and subsidiary are exchanged. In some cases, no payment may be required.

The point is that funds spent directly or indirectly on the purchase of foreign technology are also Canadian expenditures, or inputs, on the products of research and development and a further indication of the capacity and willingness of domestic industry to adopt technology and to modernize. An

[35] Statistics Canada, *Industrial Research and Development Expenditures in Canada.*

important question, therefore, is whether Canadian expenditures on technology, either undertaken in Canada or purchased from abroad, on the whole provide good value.

The answer to this is more directly a problem for industrial development and science policies than for policies relating to foreign direct investment. Canada should be able to undertake more of its own R & D on an economic basis. The point that must be emphasized, however, is that importing technology may also be very economic for Canada in certain circumstances, depending on the relative costs and benefits involved. The fact that Canadian expenditures on domestic R & D are not high is not, in itself, necessarily evidence of a failure of public policy. What is important is to seek out the best possible technology available at the lowest possible price.

This is not to deny, however, that Canada may be justified in giving special assistance to the development of a new industry offering bright promise for the future, and to support that development with R & D expenditures that in the short run are more costly than the existing technology available elsewhere, if there is a reasonable prospect that industry will become fully competitive in time or serve to advance other national objectives.

TABLE 21

PERCENTAGE OF GNP DEVOTED TO GROSS EXPENDITURES ON RESEARCH AND DEVELOPMENT (GERD), TO R & D EXPENDITURES ($US) AND TO R & D MANPOWER (QUALIFIED SCIENTISTS AND ENGINEERS, QSE) FOR TEN SELECTED OECD COUNTRIES*

	GERD/GNP		R & D Expenditures (millions of $US) 1967		QSE's in R & D 1967	
Country	1963	1967	Amount	% Share	Number	% Share
U.S. (1964, 1966)	3.0	2.9	22,285	67.0	537,278	58.6
U.K. (1964)	2.3	2.3	2,533	7.6	50,350	5.5
France	1.6	2.3	2,507	7.5	49,224	5.4
Netherlands (1964)	1.9	2.3	514	1.5	15,700	1.7
Switzerland	—	1.9	304	0.9	10,954	1.2
Germany (1964)	1.4	1.7	2,084	6.3	61,559	6.7
Japan	1.5	1.8†	1,684	5.1	157,612	17.2
Sweden (1964)	1.3	1.4	336	1.0	7,395	0.8
Canada	1.1	1.4‡	828	2.5	19,350	2.1
Belgium	1.0	0.9	176	0.5	7,945	0.9
Total			33,251	100.0	917,357	100.0

*OECD, 1970, Document DAS/SPR/70.48.

†Japan Science and Technology Agency, Summary White Paper of Science and Technology, March 1969.

‡Based on revised tables of National Income.

THE COMPARATIVELY HEAVY CONCENTRATION OF CANADIAN RESEARCH EXPENDITURES OUTSIDE THE BUSINESS SECTOR

While Canada spends less on domestic research and development as a percentage of GNP than most other western industrial countries except Belgium, relative expenditures by some of these countries are not much greater than Canada's. Certainly, it cannot be claimed that in actual expenditure or in number of trained R & D personnel, Canada is in absolute terms making lesser inputs than smaller European countries like Sweden and Switzerland, or that the Canadian input is out of all proportion to that of the German, French or British efforts. This is shown in Table 21.

Compared to other western countries, however, Canada's scientific expenditures are heavily concentrated in basic and applied research, as opposed to product development activity. This is shown clearly in Table 22.

TABLE 22

PERCENTAGE OF DISTRIBUTION OF TOTAL NATIONAL R & D EXPENDITURES BY TYPE OF ACTIVITY AND COUNTRY, 1967*

Country	Development	Applied Research	Fundamental Research
Switzerland	n.a.	n.a.	14.5
U.K.	64.6	24.4	11.0
U.S.	64.3	21.6	14.1
Netherlands	48.7	n.a.	n.a.
France	47.8	n.a.	n.a.
Japan†	42.5	30.8	26.7
Canada	38.9	38.0	23.1
Belgium	37.2	42.2	20.5

*OECD, 1970, Document DAS/SPR/70.48.

†Japan Science and Technology Agency, Summary White Paper of Science and Technology, March 1969.

Between 1957 and 1967, the share of Canadian research and development expenditures performed by private industry moved in a very erratic pattern, though tending somewhat in a downward direction. There was also a sharp reduction in the proportion of expenditures undertaken in government laboratories, whereas there was a very sharp increase in the share done in the universities.

A much smaller proportion of Canada's research and development procedures is carried out in business enterprises than in any other western country. The figures for 1967 showed that only 37.7 per cent were carried out in business enterprises. In other countries, the figures range from 54.2 per cent to 76.5 per cent. This is shown in Table 23.

TABLE 23

DISTRIBUTION OF NATIONAL R & D EXPENDITURES BY SECTORS OF PERFORMANCE AND COUNTRY, 1967*

	Business Enterprise	Government	Higher Education	Private Non-Profit
Switzerland	76.5	6.3	17.1	—
Sweden	69.9	14.2	15.5	0.4
U.S.	69.8	14.5	12.2	3.6
Germany	68.2	5.1	16.3	10.4
Belgium	66.8	10.4	21.4	1.3
U.K.	64.9	24.8	7.8	2.5
Japan	62.5	13.0	22.9	1.6
Netherlands	58.1	2.7	17.7	21.5
France	54.2	32.1	12.9	0.8
Canada	37.7	35.6	– 26.7 –	

*OECD Document DAS/SPR/70.48, Table IV. Note that figures may not add to 100 per cent because of rounding.

In view of Canada's comparatively low domestic expenditures on research and development and the fact that Canada's research and development has not been concentrated on commercial exploitation, it is relatively easy to account for Canada's poor record in technological output. The low level of commercial activity, in turn, seems to reflect largely the high degree of foreign control of those industries which are research and development intensive and the preference of such firms to concentrate their product development expenditures at home.

This does not necessarily mean that in the absence of foreign control in these industries, more R & D expenditures would take place, although recent trends over the past decade of a few Canadian controlled companies in advanced technological industries, such as Northern Electric, suggest that this is a possibility. Nor does it mean that greater domestic expenditure on R & D is necessarily desirable as a general rule. This could only be concluded if it were evident that it would be cheaper and more efficient for the economy to have more domestic expenditure on R & D and less on imported R & D.

APPROPRIATENESS OF DOMESTIC POLICY FOR THE DISSEMINATION OF TECHNOLOGY

As already stated, the maximum social gain from technology comes when its potential use is most fully exploited. With a high degree of foreign ownership of Canadian patents, and a large trade deficit in technology, the beneficial aspects of the Canadian patent system are few. It protects that small proportion of holders of Canadian patents who are actually Canadian

(and even this is a limited benefit). It also helps to provide a small incentive for Canadians and foreigners to commit funds for research and development (small because of the small size of the Canadian market). In total, this is not an impressive list of reasons to have a restrictive patent systems.

The life of patent protection in Canada is seventeen years, which is often greater than the commercial life of a patented item. A very high proportion of Canadian patents are not worked in Canada. Canadian patent law makes little use of compulsory licensing.

At the same time, Canadian patent law restricts imports of patented items and prevents domestic production unlicensed by the patent owner. Indeed, patents may be taken out for the sole purpose of precluding the development of domestic products in Canada. While there are some provisions against abuse, one conclusion reached by a recent Economic Council study of patents[36] was that for a country which is so heavily dependent on foreign technology, Canadian patent legislation is much too restrictive. It protects inefficiency and is generally costly to the economy. It goes too far in protecting owners of technology who are in any event largely foreign, and does not go far enough in ensuring rapid dissemination of patented knowledge in Canada.

As for unpatented technology, including technology in the public domain, government policy now does little to ensure its rapid dissemination. Some positive programme for seeking out alternative sources of such technology might be a part of a Canadian industrial development strategy, a point that is elaborated on later in this chapter.

FACTORS AFFECTING THE FORM AND PRICE OF TECHNOLOGY TRANSFERS

The evidence cited above suggests that Canada's low technological output reflects the economic environment and the comparatively low expenditure inputs which that environment generates. This does not mean that Canada is technologically deprived—that Canadians are obliged to live without the benefits of modern technology. On the contrary, it means simply that Canada tends to import a very high proportion of its technological requirements. The questions at issue are whether it would be more economic for Canada to produce more of its own technology, whether imported technology is imported in an appropriate form and at a fair price, and whether it is being disseminated as fully and rapidly as is desirable.

It was pointed out previously that the United States environment has proved particularly conducive to generating new technologies and products and that this is also becoming more true of the European Economic Com-

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[36] Report on Intellectual and Industrial Property, Economic Council of Canada, January 1971.

munity and, to some extent, Japan. The foreign proprietor of a new technology, if he is a good businessman, naturally seeks to maximize his return from it. In many cases, the investment he undertakes is based upon returns expected only from his home market. Any sales which he can make outside the home market provide him with a greater return than he originally contemplated because the goods can be produced at incremental cost. The incremental cost does not include any part of the original outlays required for research and development, which will have been recovered through the price charged for sales in the home market alone.

But whether or not the foreigner's initial investment in research and development was made on the expectation of selling in his home market alone, or was also based upon anticipated export markets, is not the central issue from the viewpoint of the importing country. For it, the issue is to get the imported technology for as low a price as possible. In considering such a price, however, two factors must be taken into account. One is that, if all countries insist on too low a price, the incentive for the foreigner to innovate may be reduced. The other is that, below a certain price, the foreigner may be unwilling to sell. Thus, while consideration may be given to ways of obtaining Canadian access to foreign technology at the most reasonable price possible, it must be recognized that there are always practical limits to what can be achieved.

The method the foreign proprietor prefers to use in transferring his technology will, of course, be based on what will provide him the best possible return on his investment. In practice, there are many factors which will create an incentive for the proprietor to transfer his technology by making a direct investment in the host country. For one thing, he will normally wish to maintain control over market development, especially where the expected life cycle of the technology is long and this creates a preference for direct investment. If the host country lacks sufficient human resources to exploit his technology, the proprietor may be reluctant to train them, not only because of the cost, but because of a concern that he may be creating local skills which can be subsequently used in competition with him. Furthermore, if there is a lack of local skills, a long period of close association between the owner of the technology and the firm which exploits it abroad may be necessary because the transmission of management systems, control systems, production standards and so on may be at stake, in addition to the technical information itself. Concern about local skills, incidentally, is probably not an important determinant when foreigners transfer technology to Canada. More generally, transfer via direct investment minimizes the risk of disclosing valuable "know-how" to firms that are not affiliated.

In addition, there are other factors which will also tend to create a bias in favour of direct investment. If the technology of the proprietor only constitutes a part of the entire range of his products, he may not be prepared to license the technology for any single one so that he can retain a full line to compete with others in his industry (e.g., an electrical appliance manu-

facturer). The proprietor may also be reluctant to license firms in the host country lest any sub-standard development of his technology reflect on his reputation, not only in that country, but also elsewhere in the world. For United States firms, anti-trust legislation tends to create a preference for transfer by direct investment rather than licence, as this gives the proprietor greater freedom in restricting the market to which the host country may be permitted to sell.

On the other hand, the proprietor may favour licensing where the gains which he can extract are maximized because the host market is small, the product-life short, his market position weak in the host economy or likely to be short-lived or the market power of a would-be licencee in the host economy substantial. The proprietor may lack the finances or management resources to enter the host economy by direct investment or to adapt to local conditions. Furthermore, direct investment may be blocked or very risky either economically or politically. The would-be licencee may have something to offer (e.g., cross-licensing), or the host environment might generate patent litigation or competitive products if the firms in the host country are not given access to the technology.

From the viewpoint of the importing country, when such technology is imported through direct investment, it may pay not only for the technology, but for management and many other supporting services imported with it—things which may not be in short supply in Canada. By getting a package, the importing country may be getting and paying for more than it needs or wants.

As Canada tends to import proportionately much more of its technology than virtually all other advanced industrialized countries, it has a relatively greater interest in ensuring that the method through which it obtains this technology and the price it pays for it are the best that can be obtained, an interest the foreign proprietor does not share. His concern is to maximize his return and this will not necessarily result in a transfer at a fair price or in an appropriate form for Canada. While the availability of foreign technology has, in general, clearly been essential for the Canadian economy, the method of transfer has typically been dictated largely by the objectives and interests of the foreign proprietor. Nothing in the Canadian environment militates against this procedure.

SOME COSTS OF IMPORTED TECHNOLOGY AND THE IMPORTANCE OF DOMESTIC TECHNOLOGICAL CAPACITY

Canada pays a price for the technology which it imports, whether it is through direct investment or on licence. Firstly, it pays a financial price. As indicated above, the Statistics Canada figure of $63 million paid for foreign patents, licences and technical "know-how" is probably a substantial under-

statement of payments.[37] The point, however, is that some form of payment is normally involved when technology is imported. The question is whether the price is generally a fair one.

Beyond financial costs, there are additional effects of Canada's dependency on imported technology. One is that the Canadian industrial environment is not especially likely to generate distinctive technical competence for export markets. The absence of indigenous technological capacity may tend to lead to an industrial structure which reflects the priorities of those outside of Canada. Canadian firms will produce those lines assigned to them by parent firms based upon the latters' technological achievement. This outcome is in part attributable to natural economic factors and to domestic economic policies, which make it logical in terms of cost considerations. In some cases, they reflect also restrictions imposed by foreign proprietors on the use of imported technology by Canadian licencees and affiliates.

If Canada's technologically based industries continue to be largely controlled from abroad, there is the danger that more and more of Canada's future export possibilities will be precluded from developing by decisions taken elsewhere, unless public policy is able in some way to influence private decision-making. Consequently, to the extent that Canada will continue to rely upon foreign technology, it is important to try to obtain it in those forms which will maximize industrial benefits for Canada. In some cases, this may mean importation under licence. If it is through direct investment, it may be preferable on a basis which will give the Canadian subsidiary freedom to integrate from the research stage through to development and production for Canadian and world markets. In this connection, it was pointed out above that R&D expenditures tend to be undertaken by subsidiaries most often when the subsidiaries have an entirely separate product line.[38] The kind of rationalization which is best in a particular industry, however, will obviously have to take into account the numerous other factors influencing industrial development.

A second cost of Canada's dependence on imported technology is that it may be less well adapted to the Canadian domestic market needs or production conditions. Canada becomes the captive of foreign technology and the tastes or consequences which that embodies. Furthermore, this potentially rigid pattern may well be maintained beyond the technological feature which gave rise to the initial direct investment. Thus, once a group of foreign controlled firms are established in Canada, they tend to perpetuate their position. This means that the technology likely to be made available in Canada is determined by the existing parent-subsidiary relationships and that Canada is less likely to "shop around" for alternative technology which might be more suited to Canadian needs at some future point in time.

Thirdly, there is a cultural impact on the domestic environment resulting from the import of foreign technology that is the product of values and

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[37] See earlier remarks on "technological output".
[38] Ibid.

problems as perceived by the originating country. While these may accord with Canadian values or its social system, they also help shape the domestic Canadian environment.

Fourthly, because of the heavy dependence on imported technology, employment opportunities in research and related managerial and marketing activities are reduced.

All these costs, to a greater or lesser extent, are borne by Canada. Moreover, the great success of the United States in penetrating world markets through its technologically intensive industries and the growing importance of these industries in the international economy suggests that Canada should encourage the further expansion of domestic research and development capacities which are not under foreign control. This would help to reduce the truncation of Canadian business decision-making and business operations and would help to free Canadian firms from foreign business decisions excluding them from foreign markets. As Canada cannot afford such R & D expenditures in all lines of production, it must be the task of industrial development strategy to help identify those sections in which Canada's efforts should be concentrated.

Indigenous technological capacity is also important for other reasons. Firstly, if some form of review agency were adopted, its success in negotiating with foreign investors would, at least in part, reflect its bargaining strength, which in turn would depend upon the alternatives which are available to Canada. In the absence of any significant domestic technological capacity, the bargaining hand of the review agency is bound to be weaker than if such capacity were already available. Secondly, no matter what domestic strength is developed, Canada will have to continue to rely upon a large amount of imported technology. If Canada is to buy wisely and cheaply, it must have personnel with substantial technical knowledge and experience.

CONCLUSIONS

Canada is very heavily dependent on foreign technology, much of which enters in the form of direct investment.

Some reasons have been adduced for suggesting that it is in the Canadian interest to reduce the degree of Canada's dependence on external sources. However, even if Canada increases its commercial technological output very substantially, it will still remain very heavily dependent on external technology. For the great range of Canadian needs, technology will have to enter either in the form of finished products, direct investment or on licence.

A number of important conclusions emerge from these facts. Firstly, as a country likely to remain an important importer of technology, it is sensible to take special care in developing a strong capability in buying technology.

In the case of proprietary technology, it has been pointed out that the interests of the proprietor need not coincide with Canada's. Other countries have demonstrated that it is feasible for a government to intervene in the process of technological transfer to satisfy national objectives. This would involve a process of negotiation, both on the terms in respect of which direct investment enters Canada and on the terms of arm's length licence agreements.

Secondly, several cogent reasons exist for further strengthening indigenous technological capacity: to reduce the proportion of output which is in truncated forms; to strengthen Canada's bargaining capacity in respect of imported technology; to help create the technological and entrepreneurial environment needed in Canada; and to help create the capacity to buy foreign technology. In this regard, government support for research and development should continue to be based upon "benefit to Canada" provisions. The danger of Canadian developments being exploited commercially elsewhere or being wasted (by decisions of parent firms to cut back on Canadian R & D programmes partly funded by government money) reflects the truncation of many Canadian subsidiaries.

Finally, domestic policies ought to reflect Canada's present position as a heavy net importer of technology. Current levels of patent protection run counter to the objective of ensuring rapid dissemination of technical information through the economy.

Certain aspects of these general conclusions are elaborated on further below. The points not further treated here relate to the methods through which domestic technological output ought to be improved and the sectors in which it should be concentrated. These are the tasks of other government policies, particularly industrial development policy and science policy.

THE REVIEW PROCESS

The above analysis points to a further role that could usefully be performed by a review authority.

In negotiating with would-be foreign investors, in particular multinational enterprises, one role for a review agency could, where appropriate, be to bargain for the location of research, development and innovative activities in Canada. This is not to say that the review authority would always achieve everything that might be wished. But to the extent it was successful, it would bring benefits to Canada that otherwise would not be available in many cases.

Secondly, consideration might be given to authorizing a review agency to bargain for the importation of foreign technology through arm's length licensing agreements or joint ventures, rather than direct investment, when this seemed to be the cheapest or most efficient way for Canada to obtain foreign technology.

Thirdly, for both the parent-subsidiary and arm's length relationships, the review authority might be given the power to look at the terms of royalty agreements, management fees, R & D charges, etc. to determine whether or not they were fair and reasonable.

Fourthly, to the extent that a foreigner may wish or be requested to find a Canadian licencee, he has the power to play one Canadian off against the other and against the alternative, which is to make a direct investment. If the potential Canadian licencee represents access to only 10 per cent of the Canadian market, his bargaining power with the foreign proprietor of technology is not as great as if he can command 100 per cent of that market. At the extreme, the logic of this could suggest that the Canadian government should purchase the technology at the best terms it can achieve and then, in turn, either sell or make the technology freely available to Canadian industry. Short of such an approach, the review authority could call on the technical expertise of its own staff or resources available elsewhere in government to assist a would-be Canadian buyer in searching out alternative sources of particular kinds of technology, to assess the value of the technology and to suggest to the would-be buyer and seller what terms would be considered to be reasonable; that is, the review authority could act as a counterweight to the bargaining position of the proprietor of the technology.

Finally, and more generally, the review authority could explore the alternative approaches to obtaining foreign technology, for example, through management contracts and other kinds of arrangements with the foreign proprietor.

The question arises whether Canada should buy into the future "high growth, high technology" industries by directing the funds it is prepared to allocate to technological development exclusively to Canadian controlled firms. The government could also create a special fund earmarked for Canadian firms only. The evidence suggests, however, that government foreign ownership policy ought to be based primarily, although not exclusively, on the behaviour of firms, rather than country of control, *per se*. Therefore, in establishing the criteria for the allocation of research and development funds, care must be taken to avoid nationalism for its own sake, rather than for the sake of achieving the government's economic or other objectives.

This does not mean that the government should be indifferent to the origin of control of firms to which it gives grants for research and development, or firms to which it allocates large funds as part of "major programmes" along the lines of those described by the Science Council. In those cases where funds for research and development are confined to Canadian controlled firms, it ought to be on the basis that they are likely to yield the greatest benefit in return or to best serve other national objectives. Where support is provided to firms that are foreign controlled, the benefit to Canada should likewise be the prime consideration.

At present, part of the philosophy underlying PAIT and IRDIA programmes is that public funds expended must result in commercial exploitation of any developments in Canada. However, PAIT and IRDIA funds are not the primary way in which the government contributes to R&D activity in Canada. Apart from the tax concessions, government contracts for major new products or systems (e.g., Telesat) and grants under the Defence Industry Productivity (DIP) programme are clearly more important.

While one would want to proceed on a case-by-case basis in awarding contracts for major government spending programmes, the bias in the system ought to favour those firms that are most likely to follow through with full commercial exploitation in Canada. This normally means Canadian controlled firms, or foreign controlled firms, which are rationalized in such a way that they are able to exploit product developments both for Canadian and for foreign markets. Even in the case of the Canadian subsidiary which has autonomous operations for a certain range and can produce for world markets, there is the risk that part of the "know-how" will leak out of Canada, if only through movement of personnel between various affiliates of the various multinational enterprises. Thus, it is believed that in major government expenditure programmes the concern about truncation, and to a lesser extent about "leakages" from relatively untruncated firms, fully justifies a degree of bias in favour of Canadian controlled enterprises. Nevertheless, a case-by-case approach is still preferable, as other factors will always have to be taken into account, including most importantly the degree of competence of the Canadian and foreign controlled firms bidding for the contract.

DOMESTIC POLICIES

Appropriate changes in the Canadian patent policy should be considered to ensure that a more rapid rate of dissemination of the knowledge purchased through imported technology is made available to as many Canadians as would wish to use it. This could be achieved both through shortening substantially the period of protection afforded the owners of technology and through arrangements for compulsory licensing by the Canadian licencee.

Indeed, the government might wish to consider going further by actively promoting the distribution of information on technology to the Canadian industrial community with a view to making Canadian business more conscious of recent scientific and technical developments and alternative sources of obtaining these developments. The review agency, or another body of government, might gather systematically the most up-to-date information on foreign and Canadian technology, whether it is proprietary or in the public domain. Such a service for domestic industry could provide important benefits to the economy, whether or not a review agency is established.

Chapter Nine

THE IMPACT OF DIRECT INVESTMENT ON CANADIAN MANAGEMENT

INTRODUCTION

The analysis presented thus far has suggested that foreign direct investment enters Canada for two major reasons. Part of the explanation relates to external factors, which reflect foreign priorities and capacities; the other is that similar Canadian skills and capabilities have not been developed, are in short supply or are not well-mobilized. In each case, the explanation may reflect economically rational international specialization or arbitrary distortions of the economic process.

With respect to the weaknesses in Canadian capacities, the discussion above dealt with gaps in the capital markets and the low level of Canadian technological output. The discussion on capital markets suggested that Canada should be able to look to the leaders of the financial institutions for more entrepreneurship, not just in the running of those institutions, but in respect of the entire economy. On the other hand, it must be recognized that much of the entrepreneurial drive has to come from the manufacturing, service, and resource sectors of the economy. The fact that such a high proportion of the economy is controlled from abroad indicates that a large amount of the entrepreneurship for the economy is provided by foreigners. Thus, this raises the question of whether there is a "management" or "entrepreneurial" gap in Canada which helps draw in this investment. Is the high level of direct investment partly a result of this gap? This is the first of the two issues examined below.

The second issue is related to the first. It is concerned with the impact which extensive direct foreign investment has upon the quality of business decision-making in Canada and on the development of a strong Canadian management and entrepreneurial capability (and, by implication, the consequences of doing without such a capability).

In considering the relationship between foreign direct investment and Canadian management and entrepreneurship, it is important to bear in mind that both are heavily influenced by the environment within which they operate. The economic conditions and industrial environment in the country, the cultural milieu, and a variety of public policies all bear heavily on the

supply and effectiveness of Canadian management and entrepreneurship, on the volume and nature of foreign direct investment in Canada, and on the kind of impact which foreign management has on Canadian business management development.

THE ROLE OF MANAGEMENT

The management of a firm is concerned with several kinds of functions. Its primary responsibility is to establish goals, based on which it determines its strategy. Then, within this framework, it mobilizes and allocates resources, and employs them to meet its objectives. Thus, the role of management is crucial to the performance of the entire economy.

In establishing goals and strategies, management is in effect carrying out its entrepreneurial functions. These may be decided only once in several years, or they may be subject to continuing review. In either case, they require more than the knowledge of the specialist. They are a manifestation of the drive and overall capacity of the most senior levels of management and an indication of their capacity to plan for and succeed in developing their enterprise. The way in which management performs collectively has, in turn, an important impact on the economy as a whole.

In mobilizing and allocating resources, and in seeking to ensure their efficient use, management carries out the many special functions related to the achievement of its goals, such as finance, product planning, technological development, production and marketing.

If, in fact, there is a serious shortage of managers in Canada, or in their quality, this could partly explain a certain amount of the direct foreign investment in Canada. For instance, a shortage of entrepreneurship or of particular skills, or an inferior quality, may result in Canadians failing to perceive or capitalize on business ventures which superior foreign skills are able to exploit. On the other hand, a high level of foreign investment due to other external and internal factors (including the domestic economic environment) could itself help create a gap, which would then draw in additional investment.

As a practical matter, in assessing the reasons for the current high level of direct foreign investment, it is difficult to establish whether there is a managerial gap which is separate from the gaps in technology or in capital markets. That is, it would be very difficult to prove definitely that a managerial gap exists and is a major reason for the level of direct foreign investment in Canada. Partly, this is because the absence of entrepreneurship in Canada may only be identifiable through the absence of the results of entrepreneurship, such as product innovation and technological advance.

Nevertheless, there are certain indications that a gap may exist. In comparison to the United States (which is the most relevant comparison as it is United States controlled firms that are most numerous among the foreign controlled firms in Canada), the formal educational attainment of the Canadian

owner-management group appears to be much lower on the average. Moreover, the gap was wider in this group than almost any of the categories of the labour force. According to the Economic Council, Canada is especially far behind the United States in the proportion of resources devoted to the field of university business education and university business research.

In proportion to population size, United States universities have four times as many graduates with first degrees in business and commerce, seven times as many graduates with masters degrees in business, and at the doctoral level the discrepancy is very much greater. Other evidence shows that at the beginning of the 1960's a very much higher proportion of United States managers than of Canadian managers had some university education.

While unfortunately the evidence is very thin, there are some indications that there may have been an absolute shortage in management personnel in the past. However, this is very difficult to verify, partly because of the difficulties in defining a "manager" and in defining the appropriate workload that an individual manager can handle. Leaving aside this question, it remains abundantly clear that Canadian management as a whole has a lesser amount of formal education than United States managers and that this in itself is a manifestation of a gap in the quality of management. And while the relationship between levels of education and quality of senior business leaders can perhaps be argued (it is possible that the entrepreneurial qualities of a chief executive officer are not at all related to his formal education), it seems beyond question that the quality of second, third and fourth level management, which is responsible for supervising and executing a variety of specialized functions, is very closely related to educational achievement.

Canadian management may also be less experienced than United States management in undertaking the kind of planning and marketing systems that are required in the large multi-plant operations, which are becoming progressively more important as a result of the increasing concentration of business. Because of the very large size and diversity of the United States market, United States management had to develop the necessary control systems and administrative techniques for multi-plant operations in the United States earlier in this century, when the national corporation came to dominate United States corporate life. Thus, the United States had a head start on other countries in planning multi-plant operations and in developing their techniques for diversified markets. This proved helpful when opportunities for expanding manufacturing operations to other countries began to arise. In this respect, United States management has had an important advantage over Canadian management and the management of other countries. Indeed, many non-United States controlled international firms rely heavily on United States management and marketing techniques.

It should also be noted that the United States economic system seems to have permitted greater freedom and mobility for the individual entrepreneur than the Canadian system. It was not very long ago that large portions of Canada's population were effectively frozen out of top jobs in Canadian

business. Persons who were not of Anglo-Saxon extraction appear to have had more difficulty in penetrating the senior levels of many corporations. They often found it difficult also to obtain the support and assistance for their own smaller businesses from the large corporations, further stultifying their growth capabilities. While the price paid by Canada for blunting such entrepreneurial and management talent as may have existed in these groups is not calculable, one cannot help but suspect that it was indeed considerable.

Thus, in comparison to the United States, there has been something of a management and entrepreneurial gap in Canada. Canadian management has been less educated and more concerned with social standing than ability. United States management seems also to have been much more advanced in marketing techniques and in the development of control systems.

THE IMPACT OF DIRECT FOREIGN INVESTMENT ON CANADIAN MANAGEMENT DECISIONS

In general, there are two routes through which foreign firms influence decisions of subsidiaries. One is through centralizing certain decisions in the parent firm and through the establishment of control systems which limit the discretion of the subsidiary (even on issues where it has ostensible autonomy). The other is through the control of appointments to the board of directors and senior executive positions.

DECISION-MAKING AUTHORITY OF THE PARENT

Most parent companies either make directly or control closely the major strategic decisions of their subsidiaries. While there may be significant exceptions, and a wide range of experiences from one firm to the other, Canadian subsidiaries seem generally to have little or no authority to make important financing decisions—such as to take independently the decision to undertake major capital investment—to plan with respect to new product lines or to otherwise control innovative activity and the research and development activity related to it. Even with respect to less sweeping questions, such as production planning, labour relations or marketing in Canada, for which there may be a greater degree of autonomy in the subsidiary, a Canadian firm is likely to be working within a framework established by the parent and indirectly subject to its control.

These realities reflect the logic of direct foreign investment and the way it is organized. As indicated previously, a firm extends its activities abroad as a part of an overall goal and strategy. It may be doing this to obtain new markets or to protect old ones. It may wish to acquire a safe supply of natural resources or to preclude a competitor from getting them. Whatever the motive, the multinational firm is a total business system and inherent in it is some degree of truncation of foreign affiliates. The relationship is not

normally a static one, under which the parent firm dictates unilaterally the scope of operations of each subsidiary. The management of the subsidiary obviously seeks to influence senior management at headquarters. There is a two-way flow of ideas, arguments and people. But ultimately, the sub-unit—the subsidiary—must accommodate the international strategy of the parent. Almost by definition, this means that it cannot continuously maximize its objectives.

This, of course, implies that the Canadian environment will likely have smaller impact on business decision-making of subsidiaries than it will for the Canadian controlled firm. Federal and provincial government ministers and officials are unable to have the close and continuing contacts with the top management of the parent of a foreign controlled subsidiary than they have with senior officers of Canadian controlled firms. It is, therefore, much more difficult to convince the foreign controlled firms to recognize Canadian objectives and needs when they set their priorities. These firms necessarily are involved in the formulation of a global strategy. Moreover, with the continuing revolution in the means of communication, the likelihood is that the headquarters of the international firm will come to exercise a progressively greater degree of control over the decision-making of the subsidiary firm.

Some significant benefits, in the form of management skills, can be obtained from foreign direct investment. It is probable that the foreign firm has at its disposal, in many cases, a higher qualitative level of managerial skills than its subsidiary and, therefore, that the professional capacity which is brought to bear at headquarters in making a decision concerning the business of the Canadian subsidiary may, in fact, be superior to that which could otherwise be mobilized in Canada. The foreign firm may also make available to the Canadian subsidiary the most up-to-date management systems and, in so doing, increase the capability of the subsidiary in making those decisions in which it has some autonomy. This would not only improve the efficiency with which the subsidiary is run, but also aid in the development and training of the Canadian managers of the subsidiary as they gain experience with these systems. As management is relatively mobile, skills which Canadians learn while working for subsidiaries can be transmitted through the economy as individuals move from one firm to another. The establishment of subsidiaries in Canada probably also offers Canadians more management opportunities, both at home and abroad, particularly at middle management levels, than would otherwise be available to them. More generally, it is possible that in some instances—even as a long-term proposition—there may be cost and efficiency reasons for reserving for the foreign parent outside of Canada certain decisions about the operations of its Canadian subsidiary.

At the same time, it is not entirely clear that there is anything inherent in the Canadian economic environment which precludes Canada from developing an entrepreneurial and managerial capability in some industries as qualified as those to be found elsewhere in the world. But with the opportuni-

ties for entrepreneurship limited by extensive foreign control, the environment becomes less likely to generate the kinds of persons able to be entrepreneurs. The educational system adapts to the kind of business talent needed in Canada—persons able to carry out important second and third level jobs in finance, production, and marketing. Those who are able to set the goals, determine the strategy and provide the overall direction are not likely to find a sufficient number of interesting possibilities in Canada. Of those who do demonstrate these capabilities, a significant proportion will be drawn to the United States, where there is more scope for the exercise of their talent. They will recognize that the United States is where the major decisions are made, even with respect to the Canadian business environment.

Without an environment which allows for the emergence and development of Canadian entrepreneurial capacities, a vicious circle is created in which the absence of entrepreneurship tends to perpetuate itself. At the extreme, the capability to finance, produce and market—but not to innovate—manifests itself in the miniature branch plant replica of the parent, producing the same products at higher costs for a protected Canadian market. Managing a subsidiary of this sort is doubtless demanding from the viewpoint of ensuring efficient use of resources. However, it does little to stimulate the entrepreneurial environment or to develop the entrepreneurial capacities of Canadian management. This kind of stultification is likely to exist even where there is international rationalization of production between parent and subsidiary if the critical managerial functions remain centralized in the head office of the parent firm. In brief, the direct investment package embodies entrepreneurial capacities when it enters Canada and reduces scope for Canadian entrepreneurial initiative.

It is natural that an economy with the characteristics of the United States economy should be more conducive to entrepreneurship than Canada's. With its larger market, higher incomes, higher labour costs, more competitive environment, better technological capacity and other factors discussed previously, it provides great incentives to innovation. That there is some gap between the United States and Canada is not surprising. The danger is that the current United States advantage may be so great as to further damage all Canadian capacities for innovation.

DECISION-MAKING IN CANADIAN SUBSIDIARIES

In addition to reserving for itself the power to make certain decisions, and of creating control systems which help to set the limits within which other decisions are taken, the parent companies also influence Canadian management decisions by appointing its nationals to sit as directors on the boards of Canadian subsidiaries or to serve as senior executive officers of Canadian firms. The latest data available are based on a sample of 217 firms with assets exceeding $25 million covered in the 1962 CALURA report. They show that the proportion of Canadian residents and of Canadian citizens

who are directors or presidents of Canadian firms increases as the proportion of Canadian ownership in a firm increases.

Table 24 below indicates that only 53 per cent of the directorships of Canadian firms which were 50 per cent or more non-resident owned were held by Canadian residents and only 44 per cent of the total by Canadian citizens.

TABLE 24

RESIDENCE AND CITIZENSHIP OF DIRECTORS IN FIRMS WITH ASSETS ABOVE $25 MILLION BY DEGREE OF NON-RESIDENT OWNERSHIP

Degree of Non-Resident Ownership	Total Directors	Directors Resident in Canada	Percentage of Corporations' Directors Who are Resident in Canada	Directors Who are Canadian Citizens	Percentage of Directors Resident in Canada Who are Canadian Citizens
	Number		%	Number	%
95 per cent and over	841	391	46.5	317	81.1
75 to 94.9 per cent	232	145	62.5	123	84.8
50 to 74.9 per cent	259	165	63.4	152	92.1
25 to 49.9 per cent	236	192	81.4	186	96.9
5 to 24.9 per cent	439	399	90.0	392	98.2
Under 5 per cent	155	150	96.8	148	98.7
Totals	2,162	1,442	66.7	1,304	90.4

Table 25 below shows similar results in respect of company presidents. Of firms which were 50 per cent or more non-resident owned, 75 per cent had presidents who were residents in Canada and 45 per cent presidents who were citizens of Canada.

TABLE 25

RESIDENCE AND CITIZENSHIP OF PRESIDENTS AND OFFICERS IN FIRMS WITH ASSETS ABOVE $25 MILLION BY DEGREE OF NON-RESIDENT OWNERSHIP

		President		Other officers	
Degree of Non-Resident Ownership	Corporations	Corporations with a President Resident in Canada	Presidents Resident in Canada with Canadian Citizenship	Corporation Officers Resident in Canada	Corporation Officers Resident in Canada with Canadian Citizenship
95 per cent and over	94	66	39	519	418
75 to 94.9 per cent	21	19	10	177	144
50 to 74.9 per cent	23	18	13	169	144
25 to 49.9 per cent	22	21	20	162	159
5 to 24.9 per cent	39	38	35	345	334
Under 5 per cent	18	18	17	119	101
Totals	217	180	134	1,491	1,300

The above data unfortunately do not distinguish between directors who are employed officers of a firm (internal directors) and those who are not (external directors). With respect only to external directors, it is apparent that some are actively engaged in the affairs of the firm, whereas others are mere figureheads.

While recognizing that not all Canadians are in a position to be solicitous of Canadian interests, it nevertheless seems preferable to have Canadian representation on the boards of foreign controlled firms—everything else being equal. Tables 24 and 25 indicate that there is some correlation between the degree of Canadian shareholdings of a foreign controlled firm and the degree of Canadian representation both on the board and among senior corporate officers. This suggests that one way of encouraging greater Canadian representation generally would be to require that Canadians hold at least a minority of shares in all Canadian firms.

Providing for mandatory Canadian shareholdings, however, raises a number of other major issues, which are examined more fully later in the study. But there is nothing to prevent consideration being given to the adoption of legislation providing for the appointment of a minimum proportion of Canadian directors on the boards of Canadian companies, without at the same time requiring mandatory Canadian shareholdings (a question that is also discussed more fully later).

CONCLUSIONS

While it is not clear that there has been a shortage in the number of Canadian managers available, information on the educational achievement and other related factors about Canadian management suggests that, in comparison to the United States, there has been a management gap.

One effect of a very high degree of foreign direct investment in Canada is that strategic decisions affecting a very large proportion of Canadian business activity are taken either by senior business executives resident outside of Canada, or within a central framework established by those resident outside of Canada. This is required by the logic of the multinational firm. This can have certain advantages. It may, in some instances, enable a comparatively higher level of technical proficiency to be brought to bear upon particular decisions than is available in Canada. It can upgrade the skills of Canadian management. Moreover, it can help provide the entrepreneurial thrust which is often lacking in Canada.

The dilemma is that the economic and non-economic costs can be greater than the benefits. One of the economic costs is that direct investment is likely to result in narrowing of the scope of Canadian corporate decision-making, which may lead to sub-optimal decisions for the subsidiary (though

not for the global enterprise). The impact of these limitations on decision-making capacity is likely to be felt throughout the Canadian environment. It also is likely to help perpetuate the management gap which now seems to exist and to ensure the continued weakness in the entrepreneurial environment in Canada. As for the non-economic costs, these are reflected in the political and cultural consequences of decisions being taken by non-Canadians and by the fact that foreign controlled firms are less likely to be responsive to Canadian priorities.

These considerations in turn lead to two additional conclusions and suggest a further reason for giving consideration to the establishment of a review authority. Firstly, every reasonable effort should be made to minimize the degree of truncation of foreign controlled firms already operating in Canada, so as to broaden the scope for decisions by Canadian management. This means that efforts should be made to minimize the constraints imposed upon Canadian subsidiaries, recognizing that there are obvious limitations to what can be achieved because of the logic of the way in which multinational firms operate. Secondly, this provides a further argument for careful cost-benefit analysis of all would-be foreign investment in Canada and further reason to question the desirability of investments which bring few benefits. The terms on which foreign investment enters Canada should minimize damage to Canada's indigenous entrepreneurial capabilities.

It is further concluded that, in some circumstances, there may well be grounds for helping to ensure that Canadian entrepreneurial and managerial talent is able to have the opportunity to engage in entrepreneurial activity. That is, it may prove desirable to provide special support for Canadian controlled firms, in some cases. Such an approach could not be applied in all industries without serious economic cost. Nor is it desirable, even in those industries where it is applied, to maintain such a position on a continuing basis. The door should always be left open to foreign direct investment in such industries if it has special benefits to offer. Therefore, even where protection is afforded to a particular industry, it should not be permanent, and the management enjoying it should be made to feel that it is not permanent. With these qualifications, support of this kind could prove attractive, on a selective basis, as a means of encouraging Canadian entrepreneurship and management where an industrial strategy suggested the need to concentrate on the development of certain industries, where such industries needed to be controlled and rooted in Canada, and where there was reason to believe such industries could become internationally competitive.

There is one final point to be noted. As it is sometimes possible to purchase management from abroad—for example, through consulting services and management firms—a shortage of technical skills need not necessarily result in direct investment as a means of obtaining those skills. The use of management on contract in certain Canadian mines is one illustration of this phenomenon. A review process could help identify situations in which these kinds of alternatives were preferable to direct investment.

The proposals for improving the operations of Canada's capital markets and Canada's technological capacity could contribute to an expansion of the opportunities for Canadian entrepreneurship and Canadian management. Such developments should be mutually reinforcing, with stronger Canadian management contributing to an improvement in Canada's technological capabilities and in its capital markets.

Part Four

THE IMPACT OF FOREIGN DIRECT INVESTMENT

Part Four

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Chapter Ten

THE EFFECTS OF FOREIGN CONTROL ON THE EXPORT PERFORMANCE OF SUBSIDIARIES IN CANADA

INTRODUCTION

This chapter discusses the effects of foreign control on the export performance of subsidiaries in Canada. Since comprehensive export data sub-divided between Canadian and foreign controlled companies are unavailable, a systematic comparison company by company or sector by sector is impossible. The available statistical evidence considered includes:

(i) the performance of the foreign controlled companies reporting under the Department of Industry, Trade and Commerce survey (the "reporting subsidiaries"), including a comparison of the export pattern of this group of companies with total Canadian exports;

(ii) the relationship between the degree of foreign ownership and export performance; and

(iii) a sample study of the export performance of "matching pairs" of Canadian and foreign controlled companies.

Aggregate statistical data seem to indicate that there is little difference in the general export pattern or performance of Canadian and foreign controlled firms. This is confirmed by an examination of "matched pairs" of Canadian and foreign controlled companies. These data suggest, therefore, that ownership is not an important determinant of export performance and that the general economic environment, formed by both Canadian economic policies and the tariff and other trade restricting policies of foreign governments, is the most important factor in understanding the export performance of foreign (and Canadian) controlled firms. However, the general economic environment is itself affected by the degree of foreign control. In those industries where foreign control is very high, and where Canada relies on importing technology and other inputs, domestic innovation—which often lies at the heart of good export performance by many manufacturing sectors in countries where labour costs are high—is stunted. Foreign control tends

to perpetuate the existence of an inappropriate industrial structure based on short runs of a wide variety of products and in many cases the use of technology designed basically for a larger market. Both these factors tend to raise costs and reduce competitiveness. There may also be a tendency for the foreign MNE to seek the perpetuation, at least in the short run, of foreign tariffs to protect the existing pattern of investment. Thus, the general economic environment cannot be regarded as a complete and independent explanation of the export performance of foreign controlled firms, since it is itself affected by the high degree of foreign control in the economy.

Although the export performance of Canada's manufacturing sector has improved significantly in recent years, it remains poor by comparison with a number of other industrialized countries. Various reasons are examined in this chapter in an effort to explain why this has been the case, including the existence of export restrictions on foreign controlled firms, Canada's comparative advantage in resources, and the basic determinants of trade and investment flows outlined in Chapter Three.

The evidence that the export performance of Canadian and foreign controlled firms does not differ appreciably raises the question as to why the foreign controlled firms are not doing better. One might expect that the foreign controlled firm, with the superior "distinctiveness" which allows it to penetrate the Canadian market, and with inter-related operations in various countries, would demonstrate a superior export performance. This leads to a discussion of restrictions on exports of manufactures from foreign controlled firms. It is shown that restrictions on exports from foreign controlled firms exist in a significant number of cases. It is also shown that exports of Canadian controlled firms that have entered licensing agreements with foreign firms are similarly restricted. The possible reasons for the existence of these restrictions and the techniques used to maintain them are then considered. It is noted that in at least some cases, the existing restrictions probably reflect the parent company's assessment of the relative costs of undertaking the activity in the Canadian and other economies. However, this initial judgment on comparative costs can develop into a pattern of dependence, and perpetuate itself beyond reasons that are justifiable on the grounds of cost. This could occur for a number of reasons. Firstly, the foreign controlled firm may not respond to the development of cost competitiveness in the Canadian economy because of committed costs elsewhere and perhaps non-economic biases, such as preference for location in the home economy, minimizing investment in foreign countries to reduce risks, or the existence of governmental pressures to invest at home. Secondly, as noted above, it is difficult for a foreign controlled subsidiary to develop into a centre of innovation and export of distinctive products because it is primarily a vehicle for selling foreign distinctiveness to Canadians.

There follows a brief discussion of the costs and benefits of foreign control in relation to exports and a review of the reasons why the government ought to be concerned about the export performance of foreign controlled firms. In addition to the existence of export restrictions in a significant number of cases, these reasons include the high and growing proportion of inter-affiliate trade in total Canadian exports, the tendency of foreign controlled companies to export almost exclusively to the United States market—thus narrowing the range of options open to the government, and the increasing role other governments are playing in bargaining with foreign controlled companies over the location of production and export facilities in their territories.

It is concluded that all of the factors mentioned above influence the export performance of the Canadian economy. Some, like the existence of export restrictions, pertain mainly to foreign controlled companies, although Canadian controlled companies having licensing arrangements with foreign firms are also subject to export restrictions in many instances. Other factors, such as the basic determinants of trade, affect both Canadian and foreign controlled firms. It is noted that trade in manufactures is increasing more rapidly than trade in resource products and the terms of trade are turning against some resource products. Accordingly, it is suggested that Canada should consider adoption of policies which will foster specialization and the development of greater distinctive capacities as a basis for greater exports in manufactures in areas where this is economic.

It is also suggested that consideration should be given to ways of increasing the export performance of foreign controlled companies in Canada, which in many cases should be considerably better than it is.

The chapter concludes with a discussion of policy alternatives facing the government.

Concern over Canada's export performance, especially in manufactured goods, and the effects of foreign control on this performance are justified because of the importance of exports to the Canadian economy. Canada is one of the few industrialized countries or trading areas without largely free access to a market of at least 100 million people. Consequently, export markets are crucial for the efficient and competitive development of Canadian production in many sectors of industry.[1] This is not to say that export sales are any better or more valuable than domestic sales. Export sales benefit the Canadian economy only when they are additional or incremental to domestic demand, when they increase employment or when they lead to a more efficient use of Canadian resources.

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[1] The economies of scale are not unlimited and in certain industries the Canadian market may be large enough to support efficient production if there were fewer firms and competition is maintained by reducing tariffs and other forms of protection.

EXPORT PERFORMANCE OF FOREIGN CONTROLLED COMPANIES

In evaluating the export performance of foreign controlled companies, a number of considerations must be kept in mind. Certain subsidiaries, particularly in the resource industries, have been set up in Canada in order to develop and export resource-based products. Other subsidiaries, almost exclusively in manufacturing, have been set up primarily to sell in the Canadian market. Still other companies may have been set up because of special advantages in Canada, such as cost of inputs and Commonwealth tariff preferences, and may serve domestic and export markets. Thus, export performance varies significantly from industry to industry, and even company to company within the same industry, depending upon corporate marketing strategy and a host of other economic, business and political factors.

A few other points should be noted. Firstly, there are serious limitations in the data available to evaluate the export performance of foreign controlled firms. Most of the statistics come from the Department of Industry, Trade and Commerce publication "Foreign Owned Subsidiaries in Canada". The data in this publication are compiled on the basis of voluntary reports from 326 corporations covering 972 individual companies (the "reporting subsidiaries") and are thus not a statistically representative sample. The companies covered (those having assets in excess of $5 million and majority owned by one foreign parent) are also among the best export performers so far as foreign controlled companies are concerned. No reports have been solicited from Canadian controlled companies and, therefore, there is no measure against which to assess the performance of the foreign controlled reporting companies. Other limitations of these data are noted elsewhere as appropriate. Secondly, over the period of time considered, the rate at which companies increased both their overall sales and their exports was affected by the general demand conditions for the products which they produce. Thus, rates of export growth may not entirely reflect company policies, efficiencies or aggressiveness, nor do they show whether these companies are fulfilling their export potential.

Table 26 below shows that the "reporting subsidiaries" by the Department of Industry, Trade and Commerce revealed a strong export performance over the period 1964-1969 (in considerable measure reflecting the impact of the Canada-United States Automotive Products Trade Agreement). Export sales rose by 156 per cent, compared with an increase in total sales of 62 per cent. This increase in the value of exports for the companies surveyed compares with an increase of 103 per cent for Canadian commodity exports as a whole. Similarly, export sales as a proportion of total sales rose from 18 per cent in 1964 to 28 per cent in 1969. Table 26 also shows that the "reporting subsidiaries" increased their share of total Canadian exports from about 34 per cent in 1964 to 43 per cent in 1969.

While the general performance of "reporting subsidiaries" was good, great variations occurred between individual industry groups. This is considered in greater detail below. However, one development must be highlighted here. Exports by the transportation equipment industry increased more than eightfold, due primarily to rationalization in the North American automotive industry following implementation of the Canada-United States Automotive Products Trade Agreement. If the transportation equipment sector is excluded, exports as a proportion of sales remained stable and the exports of the "reporting subsidiaries" do not appear to have performed quite as well as the Canadian economy as a whole.

TABLE 26

EXPORT PERFORMANCE BY "REPORTING SUBSIDIARIES" IN THE MANUFACTURING AND RESOURCE INDUSTRIES, 1964 AND 1969*
($ millions)

	1964	1969	Percentage Change 1964 to 1969
Reporting Subsidiaries			
Export sales	2,285	5,851	156
Total sales	13,032	21,139	62
Total Canadian Commodity Export sales	6,764	13,702	103
Proportion of Export Sales by Reporting Subsidiaries to:			
Total sales	18%	28%	—
Total Canadian Commodity Export sales	34%	43%	—
Reporting Subsidiaries less Transportation Equipment			
Export sales	1,910	2,712	42
Total sales	10,417	14,913	43
Canadian Commodity Export Sales less Transportation Equipment	6,287	9,739	55
Proportion of Export Sales by Reporting Subsidiaries to:			
Total sales	18%	18%	—
Total Canadian Commodity Export sales	30%	28%	—

*SOURCE: Department of Industry, Trade and Commerce.

A very large majority of the "reporting subsidiaries" engage in some export activity. In 1969, about 85 per cent of the companies surveyed did some export business and there was relatively little variation within various industry groups. There was no indication that the proportion of firms exporting was generally declining; if anything, the opposite was the case.

For the large majority of "reporting subsidiaries" engaged in exporting, exports are a small proportion of their total business. For about forty per cent of the companies, exports accounted for less than five per cent of sales. For nearly seventy per cent of the companies, exports were less than twenty per cent of sales. Only about sixteen per cent exported more than fifty per cent of their output. However, there was a tendency for these companies to increase the proportion of their sales exported. The number of companies increasing the relative importance of their export business appears to be larger than the number which are placing less emphasis on exports or just maintaining their export performance.

The trends in exports shown by the subsidiary companies as a whole were highly influenced by the operations of a few large companies.

THE EFFECTS OF FOREIGN CONTROL ON EXPORTS

Granting that foreign controlled companies as a whole (at least the bulk of the important ones reporting to the Department of Industry, Trade and Commerce and including the transportation equipment sector) are increasing their export sales, are exporting an increasing proportion of their production and increasing their share of total Canadian commodity exports, the question arises whether these aggregate figures conceal important differences in the sectors making up the total, with some sectors performing far less adequately than others. The impact of developments in the transportation equipment sector has already been referred to. It is also possible that exports of resources (where export restrictions are less likely to exist) are increasing relatively more rapidly than exports of manufactures (where export restrictions are more likely). Such a development would have serious implications for the creation of job opportunities for Canada's rapidly expanding labour force for at least two reasons. Firstly, resource development tends to be capital rather than labour intensive. Secondly, world trade in manufactures is increasing much more rapidly than trade in resources and the terms of trade seem to be turning against some resource industries. This means that the structure of the Canadian economy and its exports should be changing as well. Canada would be better off specializing in at least some of those manufactured products for which international markets are prepared to pay well.

Table 27 shows the structure of exports of "reporting subsidiaries" for 1964 and 1969. An attempt has been made to eliminate the effects of the Automotive Agreement by recalculating the exports of the transportation equipment sector in accordance with their historic rate of growth in the late 1950's and early 1960's.

This table indicates that exports of secondary manufactured goods constitute about thirty per cent of total exports of the "reporting subsidiaries".

This proportion increased from about 29 per cent in 1964 to 34 per cent in 1968.[2] If the effects of the Automotive Agreement are included, the rise is much greater (from 33 per cent in 1964 to 65 per cent in 1969). Resource-based exports by the "reporting subsidiaries", on the other hand, constituted about 60 per cent of total exports by "reporting subsidiaries" and decreased slightly from 64 per cent in 1964 to 61 per cent in 1969.

TABLE 27

EXPORTS OF "REPORTING SUBSIDIARIES" AND TOTAL CANADIAN COMMODITY EXPORTS BY INDUSTRY GROUP, 1964 AND 1969*

($ millions)

	1964				1969			
	"Reporting Subsidiaries"		Total Domestic Exports		"Reporting Subsidiaries"		Total Domestic Exports	
	$	%	$	%	$	%	$	%
Secondary Manufacturing								
Machinery	98.9	4.6	351.4	5.3	231.7	7.3	775.3	7.5
Transportation Equipment†	263.9	12.1	296.8	4.5	466.7	14.7	645.5	6.2
Electrical	90.0	4.1	197.6	3.0	173.7	5.5	429.8	4.2
Chemicals	108.8	5.0	280.0	4.3	151.7	4.8	398.2	3.8
Other Manufacturing	79.2	3.7	233.7	3.6	124.0	3.8	446.3	4.3
Sub-Total	640.8	29.5	1,359.5	20.7	1,147.8	36.1	2,695.1	26.0
Resource Industries								
Mining and Primary Metals	363.5	16.7	2,082.3	31.6	429.4	13.5	3,120.4	30.0
Gas and Oil	277.0	12.7	471.2	7.1	569.3	17.9	793.7	7.6
Sub-Total Mineral Industries	640.5	29.4	2,553.5	38.7	998.7	31.4	3,914.1	37.6
Pulp and Paper	749.4	34.5	2,021.2	30.7	936.1	29.4	2,949.1	28.4
Sub-Total Resource Industries	1,389.9	63.9	4,574.7	69.4	1,934.8	60.8	6,863.2	66.0
Food and Beverage	143.0	6.6	648.9	9.9	96.4	3.1	825.8	8.0
Total	2,173.7	100	6,583.2	100	3,179.0	100	10,384.1	100

*SOURCE: Department of Industry, Trade and Commerce.

†Exports of transportation equipment were calculated by taking the historic rate of growth of exports of motor vehicles and parts in the late fifties and early sixties (18 per cent) and adding an arbitrary 7 per cent to account for the effects of devaluation giving a growth rate of 25 per cent. These figures were added to Canadian exports of aircraft for the period.

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[2] The absolute figures in Table 27 should be treated with caution because of the difficulties in translating Canadian export statistics to industry categories. However, the general trends indicated are probably valid. It should also be noted that exports by the foreign controlled group of companies in the natural gas industry are understated because Trans-Canada Pipe Lines takes title to the gas it transmits and its exports of natural gas to the United States are regarded as originating in a Canadian controlled sector, even if the gas was purchased from a foreign controlled subsidiary. As a result, the above figures for exports by the gas and oil sector understate the proportion of the subsidiary companies' production going to export markets.

There are a number of possible explanations for the structure of exports of the "reporting subsidiaries," that is, for the overwhelming proportion of exports in the resource industries and the relatively smaller degree of manufactured exports. For example, this structure may reflect the existence of restrictions on exports of manufactures by foreign controlled subsidiaries. These data, however, are too aggregative to determine whether this is the case, for they may conceal important variations in export performance between various sectors or firms. Alternatively, this structure of exports (which Table 27 shows is the same for total Canadian exports, including Canadian controlled companies) could reflect Canada's comparative advantage in the resource industries and the basic determinants of trade in manufacturing and resources discussed above in Chapter Three. In discussing these determinants, it was suggested that large economies such as the United States, the EEC and Japan would tend to spawn distinctiveness in manufacturing based on their ability to achieve economies of scale or some other form of superiority, such as the ability to produce innovations in production techniques or products. A smaller nation like Canada would tend to find its export potential in relatively undifferentiated goods. It was also suggested that a country which is importing considerable amounts of direct investment is unlikely to develop those distinctive capacities which lie at the basis of exports of manufactures in sectors of high foreign control unless it has some cost advantages, some unique input, is part of an international rationalized structure, or is exporting because of governmental pressures. It was also pointed out that these are broad tendencies only. Determined government efforts to make an economy attractive as a base for innovation and exports could overcome these tendencies.

While the structure of exports confirms the general analysis of the determinants of trade, it is impossible from the data to determine what weight to assign to these determinants or any of the other factors mentioned above. Foreign subsidiaries in Canada control such a high proportion of assets in both manufacturing and resources that in many sectors a comparison between the "reporting subsidiaries" and the whole industry amounts to comparing something with itself. It is probable, however, that all three are relevant and that the structure of exports of the "reporting subsidiaries" and of the Canadian economy reflects in part the existence of restrictions on the exports of foreign controlled companies in the field of manufactures, in part Canada's basic comparative advantage in resources, and in part the underlying determinants of trade and investment (such as costs, distinctiveness, and so on).

EXPORTS BY DEGREE OF FOREIGN OWNERSHIP

A more direct way of trying to determine the impact of foreign control on exports is to see whether there is any meaningful correlation between the degree of foreign control and export performance. Such a correlation

is not obvious from the data shown in Table 28 below. Neither Canadian nor foreign controlled sectors appear to show any overall dominance in terms of export performance and the relative importance of exports appears to be evenly distributed. In 7 of 38 categories, exports accounted for more than twenty per cent of net output: mineral fuels, primary metal manu-

TABLE 28

NET EXPORTS BY DEGREE OF NON-RESIDENT OWNERSHIP OF INDUSTRY*
($ millions and percentage)

	Non-resident Ownership	Net Exports	
	%	$	%
Petroleum and coal products	97.9	10.2	2.8
Rubber products	93.7	7.2	2.4
Transport equipment	84.5	159.6	8.8
Chemicals and chemical products	84.3	215.2	14.8
Tobacco products	82.1	28.1	8.5
Mineral fuels	77.1	316.6	24.9
Machinery	70.5	154.0	17.8
Electrical products	64.3	68.1	5.9
Fruit and vegetable processing	62.2	8.8	2.6
Primary metal manufacturing	56.8	796.2	37.5
Miscellaneous manufacturing	53.5	40.4	6.8
Other mining	52.1	153.0	55.5
Textile mills	50.8	42.8	4.8
Soft drinks	49.8	.1	5.7
Non-metallic minerals	46.5	40.3	6.0
Other food products	45.5	165.8	18.3
Metal fabricating	42.1	37.6	2.5
Paper and allied industries	40.5	1,118.2	50.6
Metal mining	39.6	519.0	43.5
Dairy products	37.9	24.2	2.6
Grain mill products	31.4	68.9	12.6
Wholesale and retail trade		111.8	1.6
Wood products	27.2	394.6	37.2
Leather products	20.9	15.3	5.2
Meat products	19.5	69.7	4.3
Knitting mills	19.0	1.7	7.8
Distilleries	17.1	88.6	20.6
Business services		8.0	11.8
Furniture	15.0	2.3	6.2
Forestry	14.2	42.9	5.1
Construction	13.0	.0	.0
Printing and publishing	12.9	16.1	1.9
Bakery products	11.6	3.6	7.9
Public utilities	11.2	18.1	14.2
Clothing	11.1	8.0	9.4
Transportation and storage	7.6	558.2	16.0
Financial institutions			
Communication	.6	24.9	2.4

*SOURCE: CALURA 1966 and DBS.
NOTE: Net Exports exclude re-exports.

facturing, other mining, paper and allied industries, metal mining, wood products, and distilleries. Of these, three were non-resident controlled groups and four were part of the Canadian dominated groups. Other studies have confirmed that there is no consistent relationship between exports as a percentage of domestic production and the extent of non-resident ownership of industry.[3]

Six of the seven groups where exports exceed twenty per cent of total output are resource based. However, as in Table 27, the data do not allow one to conclude whether this reflects the existence of restrictions on exports of manufactures or Canada's basic comparative advantage in resources. It is interesting to note that in at least one sector—mineral fuels—there is significant government intervention in the form of the National Oil Policy.

EXPORTS OF CANADIAN AND FOREIGN CONTROLLED COMPANIES: "MATCHED PAIRS"

An even more direct comparison of export performance has been carried out in one study based on examining the exports of a foreign controlled and a comparable Canadian controlled company in the same industry. This approach has its limitations because in many industries there are no comparable Canadian controlled companies, either because almost all the companies are foreign controlled or because the foreign controlled companies are significantly larger. However, this study did succeed in comparing the export performance of 180 foreign controlled with 96 Canadian controlled companies in industries where both types of firm exist. It was found that there was no statistically significant difference in the export performance of these two sets of firms.[4]

This suggests that the general business environment—both domestic and international—is a more important determinant of export performance than ownership and that Canadian policy should focus on improving this environment, by lowering costs, increasing productivity and negotiating access to markets. It should not be forgotten, however, that the general business environment is influenced by the degree of foreign control in the economy. The high degree of foreign investment in some sectors—while it contributes to filling gaps in entrepreneurship, capital markets and technology—also retards the development of these capacities in Canada. This tends to impede the development of distinctive Canadian products, which are often at the base of good export performance in manufacturing. Foreign control also tends to perpetuate the existence of an inefficient industrial structure based on producing a wide range of products in short runs and employing, in many cases, a technology designed for a larger market.

[3] Cf. B. W. Wilkinson, *Canada's International Trade*: *An Analysis of Recent Trends and Patterns*, Private Planning Association of Canada, 1968, pp. 125ff, and 144ff.

[4] A. E. Safarian, *Foreign Ownership of Canadian Industry*, McGraw Hill, Toronto, 1966, Ch. 4.

Lastly, once a foreign firm has established in Canada, its parent will often seek to retain the structure of tariffs and other economic policies in the home country and in this country which led it to establish a subsidiary in Canada in the first place.

The study cited above revealed some other interesting and important conclusions:

(i) There is a substantial increase in exports as a percentage of sales as the size of the firm grows, with all firms with assets of over $25 million showing some exports.

(ii) Firms whose products were identical with those of the parent generally exported a smaller share of their output than did those whose products were different.

(iii) As the degree of overlap between the subsidiaries' and parents' products lessened, the firms tended to be more export oriented.[5]

ADMINISTERED MARKETS AND EXPORT RESTRICTIONS

While the above findings suggest that Canada should concentrate mainly on improving general economic policies and not focus special attention on the export performance of foreign controlled firms, there is ample evidence that a foreign company in setting up a subsidiary in Canada allocates the subsidiary's markets as part of its normal business strategy. This may involve restricting operations to the Canadian market or the allocation of some overseas markets to the Canadian subsidiary, such as the Commonwealth. This approach will normally apply whether the foreign company is a large multinational enterprise with global interests or simply a United States based company expanding into Canada.

Table 29 below contains an analysis of the export policy of 964 foreign controlled manufacturing subsidiaries listed in the Canadian Export Directory, published by the Minister of Industry, Trade and Commerce.[6] This table shows that 42 per cent or 339 of the 798 United States controlled manufacturing subsidiaries appear to have unrestricted access to world markets. Most of these are exporting to some extent, with about two-thirds exporting more than $100,000 per annum. The remaining 459 companies (58 per cent) operate under some type of restriction on exports: 135, or 17 per cent, are excluded from the United States market; 113, or 14 per cent, are limited

[5] This may simply reflect a greater degree of rationalization between the parent company and the subsidiary.

[6] The exporters' directory is a compendium of about 6,600 Canadian companies, including over 1,000 companies with some degree of foreign ownership, that have expressed an interest in or are believed by the Department of Industry, Trade and Commerce to be interested in exporting. Thus, the directory excludes companies that regard themselves as serving only the domestic market. This group probably includes a significant number of foreign controlled companies. A company's declaration of export interest is assessed by the Department of Industry, Trade and Commerce to determine whether it is accurate. (Natural resource companies have been excluded from this table since in most cases they have been established mainly to export.)

to the Commonwealth (these are also kept out of the United States market, bringing the total excluded from the United States to 248, or 31 per cent); 81, or 10 per cent, had some other type of restrictions (e.g., can export only to United States or developing countries, excluded from communist countries, etc.); and 17 companies, or 2 per cent, were not permitted any exports. One hundred and five, or 13 per cent, had exports allocated by the parent company; another 51, or 7 per cent, tended to use the parent's organization for export activities. In the case of companies controlled in other than the United States, 94, or 57 per cent, were apparently free to export while 72, or 43 per cent, were under some form of export limitation.

TABLE 29

EXPORT POLICIES OF SELECTED FOREIGN CONTROLLED MANUFACTURING COMPANIES OPERATING IN 1969*

(Number and percentage)

	USA Controlled		Controlled in Other Countries	
	No.	%	No.	%
Number of Companies	798		166	
No Limitations on Exports	339	42	94	57
Excluded from Parent's Market only	135	17	11	7
Restricted to Commonwealth or Parts of Commonwealth	113	14	6	4
Other Geographic Restrictions	81	10	36	21
No Exports Allowed	17	2	8	5
Exports Allocated by Parent	105	13	5	3
Uses Parent's Organization	51	7	11	7

*SOURCE: Industry, Trade and Commerce, Canadian Export Directory.

NOTE: Sums do not balance because some companies fit into more than one category.

An examination of particular companies and their export policies also reveals the existence of export restrictions affecting a significant number of subsidiaries. However, the most significant result to emerge from the study of particular cases is the wide diversity of behaviour, ranging from companies with no exports whatsoever to companies which are exporting a significant proportion of their output. This general conclusion is confirmed by the study of 180 foreign controlled subsidiaries in Canada referred to above,[7] in which a significant minority of subsidiaries were found to have export restrictions imposed on them as a result of the operations of the parent's international sales organization, the allocation of parents with restricted market rights and other reasons. Two-thirds of the respondents stated that

[7] See end of Chapter Eight, and next prior section to this on "Matched Pairs".

affiliation had little or no effect on exports, 39 stated that affiliation helped in securing export markets and 30 firms—about sixteen per cent—stated that they were prevented from exporting or could only export certain products to certain countries. There is, of course, no way of telling the extent to which these restrictions are based on the parent company's assessment of the cost situation in Canada and the extent to which they are totally arbitrary.

In addition to corporate restrictions, there is also evidence that the extra-territorial impact of other governments' laws, policies, and regulations has affected the exports of subsidiaries in some cases. The main United States laws and policies involved are: the *Trading with the Enemy Act,* the United States *Export Administration Act,* and the United States balance of payments programme, which included an appeal to United States parents to export more to their subsidiaries abroad and import less. It is likely that the British balance of payments programme has also had some effect on the exports of Canadian subsidiaries of British firms. While the impact of these extraterritorial policies of other governments on the volume of Canadian exports is difficult—if not impossible—to measure, it is unlikely that they have had a significant impact on the volume or value of Canadian exports.

Other United States laws, aimed at support of domestic industry, have also affected the exports of Canadian subsidiaries to the United States such as the *Buy America Act.* Another adverse development is the establishment of Domestic International Sales Corporations DISC. This complex tax concession could reduce or slow the growth of exports by United States subsidiaries in Canada both to the United States and to third markets, as parent companies would likely find it advantageous to handle a larger share of export business through their own DISC. The DISC could also lead to greater United States exports to Canada and lower production in this country than otherwise would be the case.

The existence of export restrictions should come as no surprise. They are part and parcel of the global marketing strategy of a foreign company. The decision how and when to enter other markets is normally one it wishes to make itself in order to avoid what, from its point of view, is needless and wasteful competition between subsidiaries or branches of the same company.

THE REASONS FOR EXPORT RESTRICTIONS

Previous discussion has already touched on some of the reasons why export restrictions exist and why a parent company is not indifferent about doing its own exporting or exporting from a foreign subsidiary, even if production, transport, tariff and other costs are equal. Leaving aside for the moment the question whether companies are profit maximizers or growth maximizers, whether they seek self-perpetuation or are primarily interested

in avoiding risk, there are a number of considerations which help to explain export restrictions:

(i) Market allocation by a parent company makes good business sense for a parent company seeking to maximize its returns on some distinctive advantage it possesses. If the subsidiary is producing the identical product to the parent firm, it is likely that exports will be closely controlled. It is unreasonable to expect the parent firm to establish companies abroad to compete with itself, although this may happen over time if the subsidiary develops some cost advantage and competitive pressures from other firms force the parent to take advantage of these lower costs. Even if the foreign subsidiary is producing and specializing in a part of the parent's product line, it may not be free to export that particular product because the parent company's marketing strategy may require breaking into a new market with the whole range of products. If the subsidiary is producing component parts, it is tied to the product development and marketing strategy of the parent company. In other words, the very nature of the parent-subsidiary relationship and the achievement of basic corporate goals (whatever these may be for a particular company) often require a degree of managerial and financial co-ordination and control from the centre, including a degree of control over exports and marketing activity. The continuing rapid improvement in communications and information systems is accentuating this centralization.

The key issue here is whether the resulting allocation of production and trade between the parent and the Canadian subsidiary accurately reflects the real pattern of relative costs. There are a number of reasons for believing that this may not be the case. In the short run, the parent may have sunk costs in production facilities at home. In some cases the investment could have a life of ten or twenty years, in the case, for example, of a smelter which would effectively exclude Canada from that portion of the industry for a considerable period of time. The parent company may wish to minimize its risks by locating as little as possible of its investment in a foreign jurisdiction. There may be other non-economic biases, such as a desire to locate in the home market for nationalistic reasons. In some cases this may be the result of government pressures. If the industry is oligopolistic in structure, the competitive pressures which might otherwise force the parent to overcome these non-economic considerations may be absent.

Closely related to the previous point is the allocation of property rights such as patents, know-how and trademarks by the foreign investor. This often leads to a network of licensing agreements involving third countries which effectively close some markets to the Canadian subsidiary. Furthermore, the parent company

probably wishes to reserve for itself possible future investments in other markets. Thus, if the Canadian subsidiary were able to enter a foreign market efficiently, it might find that it does not have the rights under its licensing arrangement (see below for further discussion of licensing).

(ii) In restricting a subsidiary's exports, the parent company may be responding to domestic laws, policies and regulations or indeed political pressures from the home government.[8]

(iii) Canada's geographic location next to the United States—the main source of direct investment, its relatively smaller size, the similarity of tastes and per capital income all pose additional problems. Firstly, there is a tendency for United States companies to treat North America as a single market for administrative purposes and to regard the Canadian subsidiary as simply another branch plant to serve the Canadian market. Secondly, a subsidiary's most attractive market is the United States, its parent's domestic market; selling in the United States (unless production has been rationalized between parent and subsidiary) involves invading the parent's backyard. This contrasts with the situation of a United States subsidiary in Europe, which has the advantage of greater differentiation and the existence of attractive non-parental markets nearby.

(iv) In some cases, institutional factors favour export from the parent company: union pressures, security of investment, tax reasons, the desire to show a profit in the parent company to retain a strong credit rating in the home market, and so on. There are also countervailing pressures from the Canadian subsidiary to expand its role, but these are normally less likely to prevail.

(v) In the short run, during which existing facilities have not yet been written off, the parent firm—if it is an MNE with production facilities in several countries—may attempt to protect the investment it has sunk in these facilities from inroads by the Canadian affiliate, especially if the other facilities have excess capacity. It should be borne in mind that export restrictions normally provide Canadian affiliates of foreign firms with a protected domestic market. To the extent that export restrictions merely reflect Canada's lack of competitiveness, this could be an important advantage. It is unlikely, however, that the market gains outweigh the market losses for Canada. In the longer run, this form of protection may not be in Canada's interest, as it tends to support inefficient production. A review mechanism could be a useful device to reduce export restrictions that are based on arbitrary factors, while acknowledging the economic legitimacy of other factors.

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[8] See the discussion of extraterritoriality above and in Chapter Sixteen.

TECHNIQUES OF RESTRICTION AND MARKET ALLOCATION

A foreign parent has at its disposal a variety of techniques to control the export activities of subsidiaries in accordance with its global marketing strategy. These range from informal understandings to licensing arrangements or limiting plant capacity to a size which is just sufficient to supply the domestic or allocated market.

Information on the frequency and impact of the various types of restrictions is unavailable. There is, for example, no systematic analysis of the use of licensing arrangements between parent companies and their Canadian subsidiaries. There is, however, some information on arm's length licensing arrangements which suggest that licensing agreements can be a vehicle for a significant degree of export restrictions. Table 30 contains the results of an analysis of 208 proposed arm's length licensing arrangements. It serves to underline the important fact that not only foreign controlled, but also Canadian controlled firms, can be subjected to export restrictions under licensing arrangements. Seventy-six per cent specified some type of limitation on exports, with 58 per cent limiting use to the Canadian market and 18 per cent (mainly from Europe) limiting use to Canada and export rights to the United States. Only five per cent proposed granting world-wide export rights. The proposed marketing rights in the remaining nineteen per cent were uncertain.

An analysis of the 28 licensing agreements that were actually concluded shows that the proportion limiting use to Canada came to 71 per cent, as opposed to 58 per cent of proposed licensing arrangements. This indicates Canadian licensees do not try to obtain, or do not succeed in getting, wider export rights during negotiations. This, in turn, raises the question whether Canadian authorities should have the capacity to examine proposed licensing arrangements with a view to removing or reducing the number of restrictions involved, provided the potential gains from exporting offset the potential loss of protection for domestic production.

TABLE 30

EXPORT LIMITATIONS UNDER PROPOSED LICENSING ARRANGEMENTS*
(1965–1969)

	Number	%
No export limitations (i.e., world-wide rights)	10	5
Use limited to Canada	121	58
Use limited to Canada and the U.S.	37	18
Undetermined	40	19
Total	208	100

*SOURCE: Department of Industry, Trade and Commerce.

Limitations on plant size can also be used as a technique for restricting export activities. It is interesting, however, that in Canada the average size of plant appears to compare favourably with that in the United States. Production runs tend to be shorter, however, with the same plant producing a wider range of products than its United States counterpart. This suggests that the average plant in Canada is of sufficient size to achieve economies of scale and to produce efficiently if wider markets were allocated to it and if its product line were "rationalized" with the parent. In rationalization schemes of this nature, it would be important to ensure that the Canadian subsidiary had significant responsibility for research and development, product innovation and marketing as well as production to avoid the loss of control.

COSTS AND BENEFITS OF FOREIGN CONTROL IN RELATION TO EXPORTS

The discussion thus far suggests that affiliation with a parent helps a subsidiary to export in some cases and restricts export opportunities in others. The question naturally arises whether, on balance, the costs exceed the benefits or *vice versa*. Let us look at costs and benefits in somewhat more detail.

There are significant benefits which can result from affiliation with a foreign parent:

(i) The use of the parent's name, research, or sales organization can reduce the cost of doing business and increase competitiveness both in Canada and in export markets.

(ii) Orders gained by the parent are sometimes channelled to the subsidiary for execution.

(iii) When the subsidiary is assigned a market, it does not have to compete against its parent or its affiliates for that market. Furthermore, the Canadian market is also protected against competition from other affiliates.

(iv) The parent company and other affiliates often provide guaranteed markets for exports from the Canadian subsidiary—markets which tend to be much less risky than those acquired through arm's length dealings.

These benefits often mean increased production, jobs and a contribution to a favourable balance of trade for Canada.

Nevertheless, the existence of restrictions in at least a significant minority of cases also involves economic costs:

(i) Export restrictions on foreign controlled companies in Canada, particularly in the manufacturing sector, can diminish economies of scale and international competitive ability. Since foreign con-

trolled firms account for a high percentage of industrial activity in Canada, export restrictions which do not reflect real costs in Canada could have a significant impact on the level of economic activity, employment, tax revenues, exports and Canada's balance of trade.

(ii) The existence of export limitations and the extent of "administered" exports from Canadian affiliates to their parent companies indicate that Canadian management of many subsidiaries is prevented from aggressively pursuing export opportunities in a number of markets. This, and other manifestations of "truncation" contribute to what has been referred to as the "branch plant syndrome".

(iii) There is evidence that a significant correlation exists in the United States between the level of R&D and product innovation on the one hand and export performance on the other. In many cases the Canadian market does not have the size to justify large-scale expenditures on R&D and product innovation. If Canada had freer access to larger markets, however, it might lead to more indigenous product development. The existence of export restraints obviously aggravates this problem.

The evidence on the existence of restrictions and their potential economic impact suggests that the contention, that Canadian subsidiaries do not export more because they are "high cost", needs to be examined industry by industry and firm by firm to determine the relative importance of higher costs and export restrictions (if any). While the Canadian business environment (the tariff and other general economic policies) within which Canadian subsidiaries operate has probably had a significant impact on export performance through the cost structure, it is difficult for a subsidiary to lower costs if it cannot obtain access to export markets because of arbitrary export limitations.

Given the present state of knowledge and information, it is not possible to determine with any precision whether there is a net advantage or disadvantage to the economy as a result of the costs and benefits associated with the export performance of affiliated companies. Aggregate data suggest, however, that the benefits could outweigh the costs, since foreign controlled companies account for a large and apparently growing proportion of total Canadian exports, not only of resource products, but also manufactured goods.[9] On the other hand, the existence of export restrictions affecting a large number of foreign controlled companies must be taken into account. In some cases these restrictions are merely an institutionalization of the relative costs of production in Canada and elsewhere but in other cases they are

[9] This estimate includes the transportation sector and the effects of the auto pact. If these are excluded, the situation is less clear. For example, Table 27 above indicates that exports of the "reporting subsidiaries" in secondary manufacturing rose 79 per cent between 1964 and 1969, while total domestic exports of secondary manufacturing rose 98 per cent. See also Table 26.

real barriers to the achievement of increased production and economies of scale. In these circumstances, where restrictions may or may not be economically justifiable, the government should have the administrative capacity to distinguish the one from the other.

ASSOCIATED EXPORT PERFORMANCE PROBLEMS

In addition to the existence of restrictions and associated economic costs in terms of the level and nature of economic activity carried on by the foreign controlled sector in Canada, other reasons for concern exist. These relate to the high proportion of exports to affiliated companies; the high degree of export concentration in the United States market; the performance of subsidiaries in other countries in comparison with Canada; and the growing degree of governmental intervention in the activities of MNE's.

EXPORT TO PARENTS AND AFFILIATED COMPANIES

As shown in Table 31, exports to parents and affiliated companies in 1969 accounted for about 75 per cent of all exports of foreign controlled companies reporting under the IT&C survey. This represented a very sharp increase from 1964, when only about 52 per cent of these companies' exports went to affiliates. This apparently greatly increased reliance on affiliates as a market primarily reflects the very rapid rise in exports of motor vehicles under the Canada-United States Automotive Agreement, with nearly all the increase in this industry being in trade between the Canadian subsidiaries and their United States parents. Exports by firms in this industry alone rose from $375 million in 1964 to $3.1 billion in 1969. In only two industry areas did exports to affiliates account for more than 75 per cent of total exports in 1969, namely the transportation equipment and the machinery and metal fabricating sectors.

However, in most industry groups, there appears to be a tendency over the period to sell a larger proportion of foreign sales to affiliated companies. It would also appear that the sectors in which sales to the parents were relatively large or in which they were increasing most rapidly were those in which exports in general were showing the most rapid expansion.

Information on the proportion of "reporting subsidiaries" exporting to their foreign parents and affiliates is given in Table 32. The figures show that the large majority of companies exporting, regardless of the industry group to which they are classified, make at least some sales to their foreign parents. This was true of more than 75 per cent of the companies in each industry group, the proportion varying in 1969 only between 75 per cent in the gas and oil group and 90 per cent in the machinery and fabricating group, with the total averaging 85 per cent. At the same time, only about 24 per cent of the reporting companies relied exclusively on their foreign affiliates

for export sales. There was somewhat more variation in the proportion of export sales going to parents and affiliates among the various industry groupings, with the proportion in 1969 varying from 4 per cent in the pulp and paper industry to 44 per cent in the machinery and metal fabricating industry. In general, there appeared to be no marked trend either in the percentage of companies exporting to affiliates or in the percentage relying exclusively on affiliates for exports. It did appear that there was a slight tendency for a larger proportion of companies to make all their export sales to affiliates.

TABLE 31

"REPORTING SUBSIDIARIES": EXPORTS TO PARENTS AND AFFILIATES

	Proportion of Total Exports going to Parents and Affiliates					
Industry Group	1964	1965	1966	1967	1968	1969
Mining and Primary Metals	72.9	69.0	68.9	67.2	66.4	63.2
Gas and Oil	63.5	61.2	61.7	66.8	64.7	67.3
Machinery and Metal Fabricating	87.3	89.5	91.2	90.2	91.2	90.5
Transportation Equipment	36.7	54.9	82.6	84.1	85.9	88.9
Electrical Products	46.9	54.4	49.5	44.8	38.1	39.0
Chemical Products	45.8	41.6	50.4	58.7	49.2	52.2
Food and Beverages	35.4	35.7	27.6	35.1	34.9	39.3
Pulp and Paper	47.8	47.3	52.7	54.4	52.2	50.7
Other Manufacturing	27.2	39.1	39.8	46.1	49.6	45.4
Total	52.0	54.5	65.4	70.4	72.0	74.7
Excluding Transportation Equipment	55.0	54.5	57.1	59.8	58.5	58.2

The growing importance of inter-affiliate trade means that an increasing proportion of total Canadian exports result from quasi-administrative decisions of a corporation in response to corporate interests and marketing strategy. The proportion of total Canadian commodity exports accounted for by the foreign controlled firms in the Industry, Trade and Commerce survey increased from about 18 per cent in 1964 to 32 per cent in 1969. This development has two potentially adverse implications. Firstly, it increases the scope for transfer price activities detrimental to Canada. More importantly, it reduces Canada's control over its domestic economy by increasing Canada's vulnerability to changes in foreign government or corporate policies. It means that a growing proportion of Canadian trade is somewhat less responsive to market forces, both in terms of purchasing from the lowest cost source and in terms of locating production in the lowest cost jurisdiction. (The government may, however, exercise a greater measure of control over the corporate policies of industries in which it has actively intervened, as in the case of automotive vehicles.)

The growing proportion of inter-affiliate trade also has implications for the government's trade and industrial policies. It could, on the one hand, speed up and facilitate a policy of international rationalization. It could, on the other hand, make it more difficult for the government to change the relative position of exports and imports in the balance of payments or to diversify Canadian export markets. European subsidiaries in Canada, if pressed to increase exports, will likely seek to penetrate United States markets. Subsidiaries of United States firms under similar pressures would also probably expand sales in the United States market, as the European and other markets would be served by European or other subsidiaries. Thus, Canada faces a difficult dilemma in that attempts to secure better export performance from foreign controlled companies might tend to integrate Canada more closely into a continental market.

TABLE 32

PERCENTAGE OF "REPORTING SUBSIDIARIES" ENGAGED IN SOME EXPORTS TO PARENTS AND AFFILIATES AND PERCENTAGE EXPORTING TO PARENTS AND AFFILIATES ONLY*

Industry Group	Exporting to Parents and Affiliates					
	1964	1965	1966	1967	1968	1969
Mining and Primary Metals						
To Parents and Affiliates	83.3	83.3	83.3	88.5	80.8	76.9
To Parents and Affiliates only	20.8	16.7	20.8	26.9	23.1	23.1
Gas and Oil						
To Parents and Affiliates	78.6	78.6	85.7	81.3	76.5	75.0
To Parents and Affiliates only	28.6	21.4	21.4	37.5	29.4	25.0
Machinery and Fabricating						
To Parents and Affiliates	88.6	73.0	86.1	83.8	86.8	89.7
To Parents and Affiliates only	17.1	21.6	27.8	24.3	28.9	43.6
Transportation Equipment						
To Parents and Affiliates	94.4	94.7	94.7	89.5	88.9	88.9
To Parents and Affiliates only	5.6	15.8	10.5	21.1	16.7	22.2
Electrical Products						
To Parents and Affiliates	95.8	95.8	91.7	87.5	82.6	87.5
To Parents and Affiliates only	20.8	16.7	25.0	20.8	17.4	16.7
Chemical Products						
To Parents and Affiliates	69.2	74.1	80.8	78.6	75.9	86.2
To Parents and Affiliates only	34.6	33.3	30.8	35.7	27.6	31.0
Food and Beverages						
To Parents and Affiliates	85.2	89.3	88.9	86.2	83.3	80.0
To Parents and Affiliates only	14.8	17.9	14.8	17.2	16.7	13.3
Pulp and Paper						
To Parents and Affiliates	91.7	87.5	84.0	73.1	76.0	84.0
To Parents and Affiliates only	20.8	16.7	16.0	15.4	12.0	4.0
Other Manufacturing						
To Parents and Affiliates	84.6	80.8	81.5	81.5	87.5	88.0
To Parents and Affiliates only	15.4	19.2	22.2	22.2	20.8	24.0
Total						
To Parents and Affiliates	85.8	83.4	86.0	83.2	82.2	84.5
To Parents and Affiliates only	19.7	20.2	21.6	24.1	21.7	23.7

*SOURCE: Department of Industry, Trade and Commerce.

Another reason for concern is the heavy dependence of the foreign controlled sector on the United States market. While this is true in the case of total Canadian exports as well, the tendency is even more marked with foreign controlled companies. Table 33 shows that the proportion of exports by "reporting subsidiaries" going to the United States increased from 60 per cent in 1964 to 82 per cent in 1969. Companies controlled in the United States increased the proportion of their exports to the United States from 62 per cent to 84 per cent between 1964 and 1969. This compares with 53 per cent of *total* Canadian exports going to the United States in 1964 and 71 per cent in 1969.

TABLE 33

EXPORTS OF "REPORTING SUBSIDIARIES" TO THE UNITED STATES*

	1964			1969		
	Total	$ to U.S.	% to U.S.	Total	$ to U.S.	% to U.S.
All "Reporting Subsidiaries"	2,784.7	1,680.8	60.4	6,269.9	5,115.3	81.6
Controlled in the United States	2,212.9	1,361.8	61.5	5,568.2	4,669.5	83.9
Total Canadian Domestic Exports	8,094.2	4,271.1	52.8	14,441.6	10,215.4	70.7

*SOURCE: Department of Industry, Trade and Commerce.

NOTE: These figures are not directly comparable with other data from the Industry, Trade and Commerce survey since it was necessary to include corporations in the financial and the wholesale trade sector to obtain comparable figures.

The growing importance of foreign controlled companies in total Canadian exports, their increasing dependence on the United States market, together with the greater rigidities involved in intra-corporate trade, mean that Canada will have increasing difficulty in diversifying the orientation of its economy (including exports), which was one of the objectives set forth in the government's review of foreign policy.

PERFORMANCE OF SUBSIDIARIES IN OTHER COUNTRIES

A comparison of the export performance of United States subsidiaries in Canada and other countries shows that in 1965 European subsidiaries of United States firms were more export oriented than their Canadian counterparts. The proportion of exports to total sales by Canadian subsidiaries was lower in most manufactured goods, including non-electrical machinery, transportation equipment, rubber products and chemicals. Table 34 below shows that by 1968 the general picture had changed. Canadian subsidiaries were exporting 28 per cent of sales against 26 per cent for European subsidiaries. However, if the transportation equipment sector (and hence the effects of

the Automotive Agreement) is excluded, the data again show that European subsidiaries export a larger proportion of sales.

TABLE 34

EXPORTS AS A PERCENTAGE OF SALES,
FOREIGN MANUFACTURING AFFILIATES OF UNITED STATES COMPANIES,
BY INDUSTRY GROUP AND GEOGRAPHIC AREA, 1968*

(percentages)

Industry Group	All Areas	Canada	Latin America†	Europe	Other
Food Products	14.4	6.6	24.2	12.3	17.8
Paper and Allied Products	44.0	61.8	7.3	14.4	3.0
Chemicals	16.8	7.3	10.5	27.5	8.9
Rubber Products	8.4	4.1	1.9	18.9	4.3
Primary and Fabricated Metals	26.3	38.0	2.3	21.6	28.3
Machinery, excluding electrical	24.7	16.4	10.0	32.9	7.9
Electrical Machinery	12.1	7.4	6.9	15.6	12.5
Transportation Equipment	28.4	44.3	1.6	26.1	2.9
Other Products	20.9	14.1	4.4	33.0	6.4
All Commodities	22.1	27.9	9.5	25.7	8.7
All Commodities (excluding Transportation Equipment)	20.1	20.7	11.0	25.6	10.4

*SOURCE: United States Department of Commerce, *Survey of Current, Business*, October 1970, p. 20.

†Includes "other western hemisphere".

It is impossible to draw firm conclusions from these statistics. The superior export performance of European subsidiaries in secondary manufacturing industries (excluding transportation) may simply reflect their greater competitiveness, trade within the Common Market, proximity to other export markets, or the fact that United States companies will normally have only one subsidiary to serve the whole European market, whereas they may have three North American bases—Canada, Mexico and the United States. On the other hand, it may reflect the existence of relatively greater export restrictions on Canadian subsidiaries because Canada's closest major market is the United States, which is the home country of most Canadian subsidiaries. The data do, however, suggest that Canada may not be getting its full share of the MNE's global exports and that efforts should be made to increase this share.

GOVERNMENTAL PRESSURES ON THE MNE

Table 35 below shows exports of the "reporting subsidiaries" as a percentage of their sales. Good export performances were recorded by firms classified to the transportation equipment, machinery and fabricating, gas

and oil, and electrical products industries. On the other hand, in the pulp and paper, chemical products, and mining and primary metals industries, exports grew over the period more slowly than did total sales. Exports of companies classified to the food and beverage industry declined. It should be noted that aside from the resource-based industries, only the transportation equipment sector exports a large proportion of output. In other industry groups the proportion of sales exported was in the area of ten per cent.

It is significant that the only secondary manufacturing sector that is highly export-oriented is transportation equipment, where government intervention in the form of the Auto Agreement led to North American rationalization and a rapid increase in exports. The Defence Production Sharing Agreement—another example of government intervention—also led to some rationalization and increased exports. This indicates that government intervention in the foreign controlled sector can, in some circumstances, help to promote the establishment of a sounder industrial structure (involving both increased exports and imports) and raises the question as to what further steps the government could or should take to gain what advantage it can from the nature of the MNE by negotiating for the location of more rational economic activity in Canada, which may include more imports in some cases. The precise form of rationalization is obviously important. Ideally, Canada should seek to have located in this country not only production facilities for export, but also facilities for R & D, product innovation and world-wide marketing if that is reasonable.

It appears that more and more governments are seeking export and other undertakings from foreign multinational firms that wish to establish in their markets. For example, when Chrysler took over Rootes in Great Britain, they were required to give an undertaking that they would maintain the same ratio of exports to production as did the auto industry as a whole. When Ford of Britain was allowed to move from majority control to complete control in 1960, it gave assurances that it would keep its exports high. When the French government gave permission to the Otis Elevator Company to take over the French company Saxby, Otis agreed to establish Saxby-Otis as a European multinational company which would export to the European market and eventually elsewhere.

In formulating its trade and other economic policies, Canada must take into account the restrictions on exports that may exist in some sectors of secondary manufacturing as part of the global marketing strategy of foreign firms. Canada must also take into account (as other countries appear to be doing) the existence of the MNE and the large volume of intra-corporate trade this entails. Recognizing that in the long run the major export decision for the MNE is a locational decision, namely where it will locate new production facilities, it follows that Canada must seek to obtain at least part of this expansion in this country if such a move could be justified on economic grounds. The MNE and its affiliates provide a natural international market to realize economies of scale which could be difficult to obtain otherwise. As

TABLE 35

TOTAL EXPORTS OF "REPORTING SUBSIDIARIES" AS A PERCENTAGE OF TOTAL SALES*

($ millions and percentage)

Industry Group	1964		1965		1966		1967		1968		1969	
	$	%	$	%	$	%	$	%	$	%	$	%
Mining and Primary Metals	363.6	47.8	367.0	45.6	389.1	44.6	410.4	46.0	466.5	48.1	429.5	43.7
Gas and Oil	277.1	9.8	287.8	9.5	331.7	10.3	399.0	11.2	508.5	13.1	569.4	13.8
Machinery and Fabricating	98.9	8.9	97.4	7.9	142.6	10.1	174.5	11.6	196.5	12.5	231.8	13.7
Transportation Equipment	374.7	14.3	501.0	15.2	1,060.9	27.5	1,748.2	37.7	2,468.6	44.0	3,138.0	50.4
Electrical Products	90.1	9.4	100.8	9.3	122.6	9.8	160.8	12.2	184.8	13.3	173.7	11.7
Chemical Products	108.9	9.7	100.7	8.3	125.2	9.4	99.2	7.2	118.4	8.0	151.8	9.5
Food and Beverages	143.0	9.7	134.5	8.9	138.5	8.3	116.8	6.8	93.8	5.3	96.5	5.1
Pulp and Paper	749.4	64.7	785.9	63.4	833.0	61.8	817.4	56.9	856.6	57.0	936.1	57.7
Other Manufacturing	79.2	7.8	84.8	7.6	89.7	7.3	92.3	7.0	105.9	7.4	124.1	8.1
Total	2,284.9	17.5	2,459.9	16.9	3,233.3	20.0	4,018.6	22.6	4,999.6	25.5	5,850.9	27.7

*SOURCE: Department of Industry, Trade and Commerce.

NOTE: Exports as reported by the companies covered in the survey represent direct sales abroad by the exporting companies. There are instances where sales abroad are made through a Canadian intermediary which takes title to the goods and then exports such goods on its own account. In these instances such sales would *not* be recorded as exports by the surveyed companies. Of particular significance in this regard are exports of natural gas which are made largely by a Canadian owned pipe line company. As a result the above figures for exports by the Gas and Oil sector significantly understate the proportion of the subsidiary companies, production going to export markets.

indicated above, the precise form of such "rationalization" and the *quality* of the activity allocated to Canada would have to be given careful consideration. It should be realized, however, that such a policy could involve greater integration of the Canadian economy with the world economy. This could reduce the degree of control over the domestic economic environment by increasing Canada's vulnerability to foreign government action, which leads to the question whether offsetting steps could be taken by the Canadian government. However, inter-corporate rationalization, to the extent that it is based on considerations of cost and efficiency, should reduce Canada's vulnerability to foreign corporate actions. In any event, these considerations underline the importance of Canada considering the maintenance of appropriate controls to ensure that production which is economically rational takes place in Canada.

CONCLUSIONS

In trying to assess the effects of foreign control on the export performance of subsidiaries in Canada, it is important to bear in mind that some subsidiaries, particularly in the resource industries, have been set up in Canada in order to develop and export resource-based products. Other subsidiaries, almost exclusively in manufacturing, have been set up primarily to sell in the domestic market. Still others may have been set up because of special advantages in Canada and may serve domestic and some export markets as well. Markets served by a subsidiary are in most cases allocated to it by its parent company as part of its global marketing strategy.

An examination of available data (admittedly inadequate for a definitive judgment) shows that:

(i) In aggregate terms, subsidiaries are expanding their export sales and exporting an increasing proportion of their production (although in no small measure this reflects the impact of the Automotive Agreement on the transportation equipment sector).

(ii) The structure of exports of foreign controlled companies and the structure of the total Canadian exports are basically the same, with about two-thirds of exports of both groups in resource-based industries. However, because of the high degree of foreign control in both manufacturing and resource industries, it is impossible to determine from these data whether the high proportion of relatively unprocessed, resource-based exports is due to basic Canadian comparative advantage in the resource industries, the existence of restrictions on exports of manufactures, or some combination of both. The structure of exports may also reflect the basic determinants of trade, and probably reflects some combination of all three factors.

(iii) A more direct test of the impact of foreign control on exports—the correlation between degrees of foreign ownership and export performance—shows that in the aggregate no such obvious relationship exists between the two variables.

(iv) An even more direct test—the comparison of the export performance of comparable Canadian and foreign controlled companies—also fails to reveal any significant differences in export performance.

(v) Nevertheless, an examination of the export policies of a large number of subsidiaries in manufacturing industries indicates that export restrictions exist in a large number of cases.

The statistical data raises the question why foreign controlled firms are not outperforming Canadian controlled firms in view of the international structure of foreign direct investment. It suggests that the general economic environment is a more important determinant of export performance than ownership. The general business environment is, however, influenced by the high degree of foreign control in the economy. Domestic innovation, which often lies at the heart of good export performance in manufacturing in economies with relatively high labour costs, tends to be stultified in those industries where foreign control is high and where Canada is importing technology and other industrial inputs. Foreign control tends to perpetuate the existence of an inappropriate industrial structure based on short runs of a wide variety of products and in many cases the use of technology designed basically for a larger market. Both these factors tend to raise costs and reduce competitiveness. There may also be a tendency for the foreign MNE to seek the perpetuation of tariffs and other economic policies both at home and abroad to protect its existing pattern of investment. The general business environment cannot, therefore, be regarded as a complete and independent explanation of the export performance of foreign controlled firms and of the Canadian economy.

This is an important issue, since trade in manufactures is increasing more rapidly than trade in resources and the terms of trade are progressively turning against many resources. If Canada does not develop greater distinctive capacities or succeed in reducing costs as a basis for greater exports of manufactures, it may not maximize its potential for high living standards which ultimately depend on the most productive use of human and other resources. It could also lead to an economy more subject to cyclical fluctuations and result in a less stimulating social and economic environment.

Without denying the benefits of affiliation and the importance of improving the general business environment in Canada, it is clear that there is a potential for better performance from some foreign controlled companies. It is known that export restrictions exist in a significant number of cases as part of the marketing strategy of parent companies or as a result of the extraterritorial application of foreign laws, policies or regulations. In some

cases, these simply reflect the relative costs of production in Canada and other markets. In other cases they are more or less arbitrary. In the latter case, subsidiaries may be prevented from exploiting potential increases in competitiveness gained through affiliation. Canadian controlled firms may also be subjected to export restrictions through licensing arrangements. While the impact of these restrictions is impossible to quantify, it is likely that they have, in a significant number of cases, reduced Canadian competitiveness by limiting the achievement of economies of scale, the scope for managerial decision-making, the possibilities for R & D and product innovation and additional tax revenues. Against these costs must be weighed the advantages accruing to Canada from the protection which these restrictions offer to Canadian production. However, in aggregate, it is unlikely that the domestic market gains outweigh the loss of export opportunities. In any event, every effort should be made to remove any arbitrary export restrictions that exist.

In addition to the existence of export restrictions in some cases, there are other reasons for concern:

(i) The proportion of inter-affiliate trade is large and increasing. In general, this trade is not as subject to market forces as arm's length transactions. The question arises whether these trade patterns, based in part on administrative decisions by foreign parent companies pursuing their own corporate interests, will respond to Canadian policy objectives and to the underlying economic circumstances. For example, the fact that a high proportion of exports of foreign controlled companies is concentrated in the United States market makes more difficult a policy of diversification, which was advocated in the government's foreign policy review.

(ii) Other governments appear to be exerting increasing pressures on foreign investors to locate export facilities in their territory. Experience suggests that foreign controlled companies respond to pressures of this sort (e.g., Chrysler and Ford in Britain, Otis Elevator in France). Unless the Canadian government arms itself with a sufficient number of levers and mobilizes its bargaining power, it may find foreign investors, particularly MNE's, making deals with other governments at Canada's expense.

POLICY ALTERNATIVES RELATED TO FOREIGN CONTROL

A number of possible policy alternatives can be dismissed summarily, in so far as they relate to export performance. A general ownership rule (e.g., requiring 51 per cent Canadian control of the voting shares of all Canadian companies) is unlikely to induce a foreign parent to locate more export activity in Canada. Indeed, the result might be the reverse, since profits

would then have to be shared on a 49/51 per cent basis. An arbitrary rule across all industries requiring a foreign controlled company to export, say twenty per cent of its output, is clearly uneconomic and unworkable, but a rule applying to one industry may be feasible.

The most promising alternative to be considered is the use of a review procedure and the resulting mobilization of Canadian bargaining power to obtain more export activity in Canada. Since a substantial degree of market allocation occurs between parent and subsidiary companies, and particularly within the multinational enterprise, a review process could seek to increase the allocation of markets to Canada. The existence of a foreign parent, and perhaps subsidiaries in other countries, would be turned to Canada's advantage to the greatest extent possible. The international structure of foreign investment would be used as a vehicle for enlarging markets and increasing exports in cases where this is economic. This, in effect, is what took place under the Canada-United States Automotive Agreement.

Since there are limits to Canada's bargaining power and what can be achieved through a review process, the government must consider other possible approaches to its objectives in the export field. One such approach, which could supplement a review process, is the development of strong Canadian controlled, export-oriented multinational companies in those sectors of industry where the MNE form of organization provides distinct advantages, where foreign investment adds no significant benefit, and where a base for efficient operations exists in Canada. Initially, this policy would probably be most effective in the resource-based industries. In the manufacturing industries, the Canadian MNE would probably pose many of the same problems as the foreign MNE in terms of maintaining strategic activities in Canada. Canadian ownership of MNE's would not remove the need to watch their behaviour carefully. This question is discussed more fully later.

Other aspects of policy considered elsewhere in this study will also affect export performance, for example:

—improvements in the general business environment, lowering costs and increasing the efficiency of the economy as a whole;

—further processing of Canadian raw materials before exporting;

—the transfer pricing provisions of the *Income Tax Act*;

—measures to counteract the extraterritorial impact of foreign laws, policy, and regulations;

—improving the quality of information on the performance of foreign controlled companies.

Chapter Eleven

THE IMPACT OF FOREIGN CONTROL ON THE PROCUREMENT POLICIES AND IMPORT PRACTICES OF SUBSIDIARIES IN CANADA

INTRODUCTION

This chapter considers the impact of foreign control on the procurement policies and import practices of subsidiaries in Canada. An examination of the growth and composition of imports of Canadian subsidiaries reveals that:

(i) Foreign controlled companies are importing about one-third of their requirements and this proportion is increasing.

(ii) Between thirty and forty per cent of total Canadian imports are in the form of inter-affiliate dealings and this proportion is increasing.

(iii) Foreign controlled companies tend to import from the country of the parent company and indeed from parents and affiliated companies.

(iv) Imports tend to be high in those sectors where foreign control is high and where parent companies are themselves exporting a high proportion of production.

(v) Foreign controlled companies appear to be more import oriented than Canadian controlled companies.

Two important questions arise from these findings:

(i) Are Canadian subsidiaries free to procure from lowest cost sources? This involves an analysis of the reasons which underlie the procurement practices of Canadian subsidiaries.

(ii) What is the impact of this procurement pattern on the development of the Canadian economy?

The answers to these questions lead to a discussion of possible alternative policies to maximize the net benefits to Canada in the field of procurement of goods and services by foreign controlled companies.

Before proceeding, it is important to make two things clear. Firstly, when a subsidiary is importing a large proportion of its requirements, there are two basic ways of reducing this volume of imports. For that portion being imported from the parent, efforts could be made to persuade the parent to locate production in Canada, if this is economic. This would lead to more efficient

production, based on a rationalized structure between parent and subsidiary, and probably result in an increase in both exports and imports. This is what occurred under the Canada-United States Automotive Agreement. For that portion of imports which the parent or subsidiary is purchasing at arm's length from third parties, efforts could be made to locate a Canadian supplier. Secondly, it is important to emphasize that a reduction in imports and maximizing production in Canada, regardless of economic cost, is not a desirable objective of policy. Efforts to increase production in Canada must be premised on it being economic to do so.

It should also be pointed out that data on procurement policies and practices of foreign controlled companies are not readily available; indeed, they are even more difficult to come by than in the case of export restrictions discussed in the previous chapter.

GROWTH OF IMPORTS OF FOREIGN CONTROLLED FIRMS

Table 36 shows that the "reporting subsidiaries" are importing about one-third of their total purchases and that this proportion is increasing. Between 1964 and 1969, imports of "reporting subsidiaries", as a proportion of their total purchases, rose from 28 to 38 per cent. In the case of companies controlled in the United States, imports as a percentage of purchases increased from 26 per cent in 1964 to 39 per cent in 1969; they decreased from 43 to 36 per cent of purchases in the case of companies controlled in Britain.

If the imports and purchases of the "Big Four" automobile companies (G.M., Ford, Chrysler, and American Motors) are excluded (and hence the effects of the Canada/United States Automotive Agreement), imports as a proportion of sales remained stable at about 25 per cent. It should also be remembered that the large imports by the automotive sector are offset by large exports because of industry rationalization. The increase in the proportion of purchases imported by United States controlled companies appears to have been offset by the decrease in the proportion imported by British controlled companies.

Because of the short time span involved, it is difficult to determine to what extent the large and increasing proportion of imports reflects a general trend, or to what extent it is merely part of a normal cyclical development. This question will require further research in future. For present purposes, it is sufficient to note that the volume and values are large and growing.

As a proportion of total Canadian imports, imports of "reporting subsidiaries" increased from 32 to 40 per cent between 1964 and 1969. Even if the transportation sector is excluded (it was not possible to exclude just the "Big Four" because Statistics Canada does not collect import data on a com-

pany basis), imports by "reporting subsidiaries" still rose from 20 to 24 per cent of total Canadian imports between 1964 and 1969.

Aside from the general qualifications which must be introduced because of the sample of "reporting subsidiaries" involved, it is important to realize that these import figures generally include duties and transportation charges within Canada (i.e., import values are mainly c.i.f.). They are thus inflated by some significant but unknown amount above the import data collected by Statistics Canada. On the other hand, purchases of imported capital equipment, if made from a Canadian agent of a foreign company, are regarded by many reporting companies as Canadian purchases, thus offsetting this overstatement to a certain extent.

TABLE 36

TOTAL MERCHANDISE PURCHASES AND TOTAL IMPORTS—
ALL "REPORTING SUBSIDIARIES"*
1964–1969

($ millions)

	Total Purchases†	Total Imports‡	%	Percentage Minus "Big Four" Automobile Companies
All "Reporting Subsidiaries"				
1964	8,740	2,430	28	25
1965	10,008	2,992	30	25
1966	11,686	3,481	30	23
1967	12,585	4,068	32	23
1968	13,504	4,966	37	24
1969	14,769	5,684	38	25
U.S.A. Controlled Companies				
1964	7,323	1,898	26	22
1965	8,457	2,445	29	23
1966	9,942	2,968	30	22
1967	10,972	3,608	33	22
1968	11,724	4,422	38	23
1969	12,864	5,043	39	23
British Controlled Companies				
1964	771	334	43	
1965	855	326	38	
1966	1,063	315	30	
1967	1,060	317	30	
1968	1,027	326	32	
1969	1,096	395	36	

*SOURCE: Department of Industry, Trade and Commerce.

†Includes merchandise purchases made in Canada.

‡Includes capital items.

NOTE: Total Dollar figures may not add exactly due to rounding. Imports are c.i.f.

Table 37 shows that United States controlled companies purchase the bulk of their imports from the United States. This concentration of import purchases in the United States increased from 84 per cent of total imports in 1964 to 92 per cent in 1969. If the "Big Four" automobile companies are excluded, imports by United States controlled "reporting subsidiaries" from the United States increased moderately from 79 per cent of total imports in 1964 to 81 per cent in 1969. Subsidiaries controlled in Britain appear to demonstrate a similar tendency of importing from the home country; the bulk of their imports (over sixty per cent) come from foreign countries other than the United States, presumably from Britain.

It should of course be remembered that the Canadian economy as a whole imports significant amounts from the United States. In recent years about 70-75 per cent of total Canadian imports have come from the United States.

TABLE 37

TOTAL IMPORTS OF "REPORTING SUBSIDIARIES" BY COUNTRY OF CONTROL*
1964–1969

($ millions)

	Total Imports				
	From U.S.A.		Other Foreign Countries		Percentage Minus "Big Four" Automobile Companies
		%		%	
U.S.A. Controlled					
1964	1,599	84	299	16	79
1965	2,114	86	331	14	80
1966	2,594	87	374	13	80
1967	3,143	87	467	13	76
1968	3,993	90	429	10	80
1969	4,615	92	428	8	81
British Controlled					
1964	119	36	215	64	
1965	134	41	192	59	
1966	129	41	185	59	
1967	121	38	196	62	
1968	114	35	211	65	
1969	136	35	257	65	

*SOURCE: Department of Industry, Trade and Commerce.

Thus far it has been shown that foreign controlled companies (including the automotive sector) import a large and growing proportion of their total purchases and that these imports tend to come from the country of the parent company. Table 38 shows that a high proportion (about three-quarters) of the imports of "reporting subsidiaries" came from parents and affiliates and that this proportion is increasing (from 67 per cent in 1964 to 76

per cent in 1969). If the "Big Four" are excluded, imports of "reporting subsidiaries" from parents and affiliates rose from 65 per cent to 70 per cent of total imports between 1964 and 1969.

Table 38 also shows that United States controlled companies purchase a higher proportion of imports from parents and affiliates than British controlled subsidiaries, but that this latter proportion is increasing at a more rapid rate.

The proportion of total Canadian imports accounted for by imports of the "reporting subsidiaries" from parents and affiliates increased from 22 per cent in 1964 to 31 per cent in 1969.

TABLE 38

"REPORTING SUBSIDIARIES": MERCHANDISE PURCHASES FROM PARENTS AND AFFILIATES*
1964–1969

($ millions)

	Total Merchandise Imports	Merchandise Imports† From Parents and Affiliates	Percentage With Parents and Affiliates	Percentage Minus the "Big Four" Automobile Companies
All "Reporting Subsidiaries"				
1964	2,430	1,628	67	65
1965	2,992	2,035	68	64
1966	3,481	2,422	70	66
1967	4,068	2,891	71	68
1968	4,966	3,722	75	68
1969	5,684	4,312	76	70
U.S.A. Controlled				
1964	1,898	1,351	71	70
1965	2,445	1,726	71	67
1966	2,968	2,156	73	70
1967	3,608	2,607	72	70
1968	4,422	3,365	76	69
1969	5,043	3,898	77	71
British Controlled				
1964	334	113	34	
1965	326	128	39	
1966	315	112	36	
1967	317	161	51	
1968	326	172	53	
1969	395	214	54	

*SOURCE: Department of Industry, Trade and Commerce.
†Including capital equipment.

Leaving aside for the moment the question whether foreign controlled companies are maximizing procurement in Canada in cases where this is economic, these developments raise a number of serious issues for government policy.

Firstly, the large and growing proportion of total Canadian imports accounted for by intra-corporate trade increases the scope for transfer price arrangements detrimental to the Canadian treasury if present laws and their administration are not adequate. This question is considered in Chapter Thirteen. Of greater significance, however, is the fact that increasing proportions of Canadian imports result from intra-corporate administrative decisions and are somewhat further removed than arm's length transactions from the disciplines of the market place. It increases Canadian exposure and vulnerability to the decisions of other governments and could make it more difficult for the Canadian government to implement some of its policies; for example, a government policy to diversify sources of imports. On the other hand, depending on the circumstances, the existence of production facilities in Canada could facilitate a government decision to rationalize a certain industry. These questions are considered further below.

COMPOSITION OF IMPORTS

Table 39 below shows that imports of the "reporting subsidiaries" are quite highly concentrated by sector. Imports were 30 per cent or more of purchases in 1968 in the following sectors: transportation equipment (70 per cent), machinery (46 per cent), electrical products (33 per cent), other manufacturing (33 per cent), and chemicals (30 per cent). Imports as a percentage of purchases are increasing in the case of transportation equipment, machinery, and electrical products. Imports tend to be small—both absolutely and as a percentage of purchases—in resource-based industries.

It is significant that all the industries in which imports represent a relatively high percentage of purchases have these common characteristics:

(i) a high degree of United States ownership;

(ii) United States parent companies that spend significant amounts on research and product innovation;

(iii) United States parent companies that export a large proportion of sales; and

(iv) Canadian exports that are low as a percentage of sales (except in those industries that are rationalized, for example, automobiles).

This would seem to confirm the analysis of the determinants of direct investment outlined earlier. It was pointed out that the development of a distinctive capacity—perhaps through research and development—leads to the ability to penetrate foreign markets either through exports or foreign direct investment. It was also suggested that foreign direct investment permits entry to a foreign market in minimal form with a number of activities retained for itself by the parent in the home economy. In these circumstances

TABLE 39

"REPORTING SUBSIDIARIES": PERCENTAGE OF PURCHASES IMPORTED*
1964–1968

	1964	1965	1966	1967	1968
Mining and Primary Metals					
Non-Capital Goods	28.4	29.5	25.2	27.2	23.2
Capital Equipment	10.0	3.4	5.4	14.4	10.9
Total	25.9	25.1	21.6	24.9	21.8
Gas and Oil					
Non-Capital Goods	25.0	24.7	23.4	22.6	26.6
Capital Equipment	1.4	3.0	4.5	7.1	11.1
Total	23.0	22.7	21.2	20.8	24.4
Machinery and Fabricating					
Non-Capital Goods	38.8	39.3	40.6	41.7	44.9
Capital Equipment	39.2	44.4	61.9	63.1	55.8
Total	38.8	40.0	43.6	45.0	46.1
Transportation Equipment					
Non-Capital Goods	44.6	53.3	56.4	63.4	71.3
Capital Equipment	33.9	39.7	32.2	32.2	32.3
Total	43.9	52.0	54.5	61.7	70.1
Electrical					
Non-Capital Goods	30.1	31.2	31.5	31.0	34.1
Capital Equipment	22.7	17.2	22.6	13.6	15.6
Total	29.8	30.2	30.8	28.3	32.6
Chemicals					
Non-Capital Goods	35.7	36.0	32.0	31.7	33.9
Capital Equipment	8.4	7.9	6.1	6.4	6.1
Total	32.9	31.3	19.1	28.0	30.4
Food and Beverage					
Non-Capital Goods	24.6	22.3	19.9	19.7	20.1
Capital Equipment	9.7	9.8	10.8	10.2	7.2
Total	24.1	21.7	19.6	19.3	19.7
Pulp and Paper					
Non-Capital Goods	7.9	7.8	7.2	6.7	7.0
Capital Equipment	6.6	6.3	4.4	5.2	6.7
Total	7.6	7.5	6.6	6.3	7.0
Other Manufacturing					
Non-Capital Goods	33.0	34.0	31.5	30.5	32.7
Capital Equipment	22.6	29.7	17.2	40.0	40.4
Total	32.0	33.5	29.5	31.4	33.4
Wholesale Trade					
Non-Capital Goods	25.6	27.1	23.6	26.0	25.8
Capital Equipment	33.3	20.0	—	20.0	48.0
Total	25.7	27.0	23.6	26.0	24.4
Other Non-Manufacturing					
Non-Capital Goods	5.1	6.1	5.8	4.4	6.0
Capital Equipment	4.2	4.0	5.1	2.8	1.3
Total	5.0	6.1	5.8	4.4	4.5

*SOURCE: Department of Industry, Trade and Commerce.

there is likely to be a substantial volume of imports by the subsidiary from the parent. This situation has serious implications for the ability of the Canadian authorities to secure greater production in Canada in these industries.

Table 40 below shows exports of United States parent companies to affiliates (i.e., imports by subsidiaries from United States parent companies). These statistics, based on United States sources, confirm the findings in Table 39. They also show that in total, and in most of the particular industrial categories, imports as a percentage of sales of the subsidiary companies were higher for Canada than for other areas in which United States subsidiaries are located. Imports by Canadian subsidiaries represented fifteen per cent of their sales, whereas imports of subsidiaries in other areas were less than ten per cent of sales. The United States Department of Commerce suggests that differences result from superior reporting practices by Canadian subsidiaries. However, there are a number of additional factors possible, such as Canada's proximity to the United States, greater similarity of product lines and less need for local adaptation. The figures suggest that the government should consider looking closely at the amount of importing by foreign subsidiaries with a view to determining whether some production could be shifted from the parent to the Canadian subsidiary, or whether goods being purchased by the parent from arm's length suppliers in its home market could be bought in Canada on an economic basis.

TABLE 40

UNITED STATES EXPORTS TO FOREIGN-PRODUCTION AFFILIATES OF UNITED STATES MANUFACTURING FIRMS BY INDUSTRY OF AFFILIATES AND BY TYPE OF EXPORTS, 1964*

Industry of Foreign Affiliates	Exports to Affiliates (millions of U.S. dollars)		Exports to Affiliates as % of Their Sales**	
	All Areas	Canada	All Areas	Canada
Food products	165	53	3.3	4.1
Paper and allied products	57	27	2.9	2.2
Chemicals	638	207	8.4	11.7
Rubber products	156	46	8.2	9.5
Primary and fabricated metals	189	74	5.2	5.1
Machinery (except electrical)	730	331	14.1	29.5
Electrical machinery	357	245	10.4	23.0
Transportation equipment	1,293	651	12.7	25.7
Other products	484	205	11.2	16.1
Total	4,068	1,840	9.6	15.1

*SOURCE: United States Department of Commerce, *Survey of Current Business*, December 1965, pp. 15–16.

**Excludes exports of capital equipment for use by foreign affiliates ($198 million) and exports for sale by the foreign affiliate on a commission basis ($275 million).

A study based on the examination of the import practices of 220 foreign controlled firms broadly supports the above conclusions.[10] It shows that roughly one-third of the firms surveyed purchased 90 per cent or more of their components, materials, and services from Canadian sources, another third purchased between 70 and 89 per cent from such sources, and the remaining third, less than 70 per cent. For the group in general, imports were largely from the United States, with about 74 per cent of the firms indicating that they took 70 per cent or more of their imports from that country. The parent firms abroad are the major source of subsidiary imports into Canada. In addition, this study reveals that:

(i) The percentage of purchases from suppliers in Canada is higher for the larger firms than for the smaller ones.

(ii) There does not appear to be much relationship between the age of the firm and domestic content.

(iii) Those firms which produce a minority or only a few of the parent's products have a higher domestic content in their purchases than do those producing a much wider range of products relative to the parent's.

The study also confirmed the conclusion noted earlier that the industries oriented to primary resources have a very high Canadian content in their purchases, while industries such as transportation equipment and electrical products, generally tend to have a significantly lower domestic content in purchases.

COMPARISON OF CANADIAN AND FOREIGN CONTROLLED FIRMS

There are very few statistics on which to make a comparison between the import practices of Canadian and foreign controlled firms. What there is, however, points in the same direction and indicates that foreign controlled firms are more import oriented than Canadian controlled firms. One study showed that 36 per cent of Canadian controlled companies bought 95 per cent or more of their materials and parts, equipment and services such as insurance, advertising, and accounting in Canada, as against 11 per cent of the non-resident owned firms which bought the same proportion.[11] Similar proportions of these firms—33 and 36 per cent respectively—made 80 to 94 per cent of their purchases in Canada, while a correspondingly greater proportion of the non-resident owned firms made less than 80 per cent of their purchases in Canada. The greater import orientation of the non-resident controlled firms persists whether one looks at all firms with assets of $1 million or more, or only at those with assets of $25 million or more

[10] A. E. Safarian, *Foreign Ownership of Canadian Industry*, McGraw-Hill, 1966.
[11] A. E. Safarian, *op. cit.*

(see Table 41 below). While these data have limitations, related primarily to the use of a survey and interviewing technique, the bias in the replies to the questionnaire would probably tend to be in favour of sourcing in Canada. The fact that the results run counter to the expected bias gives one greater confidence in the conclusion.

TABLE 41

PROPORTION OF PURCHASES IN CANADA
RESIDENT OWNED AND NON-RESIDENT OWNED COMPANIES
WITH ASSETS OF $1 MILLION OR MORE

Percentage of purchases in Canada	All firms		Assets of $25 million or more		All firms		Assets of $25 million or more	
	R	NR	R	NR	R	NR	R	NR
	(Number of firms)				(Percentages)			
95 and over	35	18	8	4	36	11	40	11
90–94	13	28	4	6	14	18	20	17
80–89	18	29	4	6	19	18	20	17
70–79	7	23	—	5	7	14	0	14
60–69	6	16	1	5	6	10	5	14
50–59	3	6	—	1	3	4	0	3
40–49	1	6	—	1	1	4	0	3
30–39	—	6	—	—	0	4	0	0
Below 30	2	7	—	—	2	4	0	0
Not available or no response	11	21	3	7	12	13	15	20
Total	96	160	20	35	100	100	100	100

	Averages for above data (percentages)					
	All firms			Manufacturing only		
First quartile	96	90	95	90	95	90
Median	90	80	90	85	90	80
Third quartile	80	64	86	70	75	65

NOTE: R means resident owned, NR means non-resident owned.

The high import propensity of foreign controlled firms is confirmed by Table 42 below, which shows the significance of imports in relation to varying degrees of non-resident ownership. There were twelve categories in which imports were significant (more than twenty per cent of output). All twelve occur in groups where Canadian dominated corporations own less than sixty per cent of total group assets. In other words, the import significant groups were confined exclusively to sectors in which non-residents had at least forty per cent control.[12]

[12] This finding is confirmed by B.W. Wilkinson, *Canada's International Trade: An Analysis of Recent Trends and Patterns*, The Canadian Trade Committee, Private Planning Association of Canada, pp. 145-ff.

TABLE 42

IMPORTS BY DEGREE OF FOREIGN OWNERSHIP OF INDUSTRY*

($ millions and percentage)

Industry	Non-resident ownership	Imports	
	%	$	%†
Petroleum and coal products	97.9	137.8	11.1
Rubber products	93.7	59.8	19.5
Transport equipment	84.5	852.5	47.2—M‡
Chemicals and chemical products	84.3	395.4	27.1—M
Tobacco products	82.1	9.2	2.8
Mineral fuels	77.1	487.8	56.1—M
Machinery	70.5	947.7	110.0—M
Electrical products	64.3	410.6	35.7—M
Fruit and vegetable processing	62.2	110.8	32.9—M
Primary metal manufacturing	56.8	300.6	11.3
Miscellaneous manufacturing	53.5	361.0	60.4—M
Other mining	52.1	56.4	20.5—M
Textile mills	50.8	407.2	45.7—M
Soft drinks	49.8	4.7	26.8—M
Non-metallic minerals	46.5	154.3	22.8—M
Other food products	45.5	173.4	19.2
Metal fabricating	42.1	341.6	23.1—M
Paper and allied industries	40.5	103.2	4.9
Metal mining	39.6	126.5	10.6
Dairy products	37.9	12.1	1.3
Grain mill products	31.4	7.7	14.1
Wholesale and retail trade		.0	.0
Wood products	27.2	71.7	7.5
Leather products	20.9	44.6	15.3
Meat products	19.5	76.1	4.7
Knitting mills	19.0	39.7	18.2
Distilleries	17.1	61.0	14.2
Business services		72.1	10.6
Furniture	15.0	35.2	9.6
Forestry	14.2	14.7	17.5
Construction	13.0	.0	.0
Printing and publishing	12.9	144.7	17.0
Bakery products	11.6	11.8	2.6
Public utilities	11.2	15.9	1.3
Clothing	11.1	61.7	7.2
Transportation and storage	7.6	80.9	2.3
Financial institutions			
Communication	.6	17.6	1.7

*SOURCE: CALURA 1966 and DBS.

†This per cent has been calculated by comparing competing imports with commodity outputs inclusive of intermediate output and after deducting competing imports. Re-exports (mainly capital equipment) are also included.

‡M—Imports larger than 20 per cent of total output.

THE FREEDOM OF SUBSIDIARIES TO PURCHASE FROM THE LOWEST COST SOURCE

The analysis to this point has indicated the large and growing proportion of imports from parents and affiliated companies; the high degree of imports in those industries in which parent companies are doing a substantial amount of exporting; the fact that imports as a proportion of sales are greater for Canadian subsidiaries of United States companies than United States subsidiaries in other countries; and the greater import propensity of foreign controlled companies in comparison with Canadian controlled companies. These facts raise the question why this behaviour is different and, in turn, a further question as to whether subsidiaries are free to purchase from lowest cost sources.

Information obtained from the Department of Industry, Trade and Commerce indicates that most subsidiaries claim to be free to purchase from the lowest cost source. Almost one-half of the 885 replies received to a letter sent out by the Minister of Trade and Commerce in 1967 stated that the respondent company sought out and tried to develop economic sources of supply in Canada as a matter of policy. A few companies stated that they were willing to pay a slightly higher price for Canadian supplies in order to establish sources in Canada because the convenience of readily available suppliers outweighed any minor price difference. One comment frequently made was that the Canadian subsidiary was allowed complete freedom in sourcing its supplies. Only twelve companies reported that they were not free to purchase from the most economic source. This conclusion is broadly confirmed by an examination of particular companies and their procurement policies, although there are some important exceptions.

A broadly similar picture emerges from the Safarian study. It found that half of the 220 Canadian subsidiaries surveyed believed that affiliation had no *direct* effect on their imports, or a limited one at most.[13] (This must be qualified, however, by the fact that indirect effects of affiliation are often significant, inasmuch as similarity of products produced by the two affiliated firms leads to substantial imports of components, as discussed further below.) Forty firms (21 per cent) indicated that the direct effects included joint purchases with the parent, contacts with suppliers and others that were described as helpful to the subsidiary. Eleven firms (six per cent) reported tied arrangements of various kinds, such as required purchases of parts from the parent or its affiliates. Thirty-four firms (eighteen per cent) indicated affiliation resulted in large purchases from the parent, although half of these explicitly stated that they could buy elsewhere if they wished.

The question arises whether this evidence of freedom to purchase from lowest cost sources is consistent with the evidence of higher import pro-

[13] A. E. Safarian, *op. cit.*, Chapter 5.

pensity given above. Several considerations seem relevant. Firstly, the evidence on the extent to which subsidiaries are free to purchase from lowest cost sources is based almost entirely on the claims of subsidiaries' management. While not invalidating the conclusion, this suggests that it should be treated with some degree of caution. Secondly, it is not clear whether the respondents to the IT&C letter were in all cases referring to total purchases (including those from parents and affiliates) or only to arm's length purchases. It is to be expected that subsidiaries would have greater freedom of choice in the case of arm's length purchases. Lastly, there are a host of other factors which help to explain why subsidiaries are more import-oriented. These are considered in the next section. In considering these factors, it should be remembered that a subsidiary has a variety of alternatives open to it to meet its needs for goods and services, such as:

—purchases from the parent and affiliates;

—purchases from the parent's suppliers;

—arm's length procurement abroad;

—arm's length procurement in Canada;

—production of its own requirements.

Since a decision to purchase within the corporate family appears to be based on different considerations than a decision to purchase at arm's length, this question is considered separately.

REASONS FOR THE HIGH PROPENSITY OF SUBSIDIARIES TO IMPORT FROM PARENTS AND AFFILIATES

Foreign controlled firms import such a high proportion of their needs from parents and affiliated companies for a wide variety of reasons. Among the most important are considerations of product distinctiveness (i.e., unavailability in Canada from any arm's length source), higher costs in Canada (due to industry structure, fragmentation of runs, and so on), and the costs of research. In addition to these three fairly clear reasons, there are other considerations related to the parent-subsidiary relationship which help to explain this high import propensity.

PARENTAL CORPORATE STRATEGY

In discussing the nature and determinants of direct foreign investment, it was pointed out that trade and investment both have similar basic motivations, that is, a desire to secure additional markets to exploit some distinctive advantage. It follows that the import content of production is likely to be high because the parent and the subsidiary usually are producing identical or basically similar products. The parent company will want

to maximize its economies of scale by producing components or end products for the subsidiary where the Canadian tariff, transportation and other costs relating to importing the component are not prohibitive. In addition, the parent will tend to resist transferring production to the subsidiary in order to minimize its investment exposed in Canada, where risks and uncertainty may be somewhat greater from the perspective of a foreign firm. Lastly, the supply of components by the parent is a convenient way for the parent to vary the repatriation of profits in accordance with the subsidiary's sales of the end product or use of the particular component.

One study of the procurement policies of twelve foreign controlled subsidiaries turned up a very significant finding in relation to the handling of purchases from the parent. In half of the subsidiaries, the study found, production materials and components bought from the parent were not handled by the purchasing department, but by the production control group—indicating that the question of alternative sources of supply did not really arise.[14]

INCREMENTAL COST CONSIDERATIONS

In deciding whether to supply its subsidiary, an economically rational parent company compares the incremental costs of production in Canada or the market price of supplies in Canada (if available) with the incremental cost[15] of producing these supplies in its own plant or in that of its subsidiary. This almost certainly biases the parent towards supplying its subsidiary, since the cost of producing in Canada or the ruling market price in Canada (which tends to be the United States price, plus transportation, plus tariff) will in most cases exceed this incremental cost.[16] Any additional use of the parent's existing capacity (provided that the parent cannot sell the product in question in some open market at a price higher than the price in Canada) can make some contribution to the costs the parent has already sunk in an investment and, theoretically at least, make the parent better off as a result.

The extent to which businessmen actually use this type of incremental cost calculation in making procurement decisions is uncertain. There is evidence that many pricing decisions are made using a rough rule of thumb based on fully allocated costs.[17] But as pointed out above, the pricing deci-

[14] M. R. Leenders, *The American Subsidiary and "Buy Canadian"*, Business Quarterly, Summer, 1965.

[15] Incremental costs are the additional costs of increasing output by a given amount. If the addition to output is small and there is some margin of unused capacity, then incremental costs include only variable costs. If, however, capacity is being fully utilized and the incremental production is substantial, the incremental costs may include additional fixed costs.

[16] The price charged to the subsidiary could the same as or higher than the incremental cost, depending on where the parent wishes to take its profits. The use of transfer pricing as a technique for shifting profits is, however, scrutinized by both Canadian and United States tax authorities. The United States authorities have been particularly active in this field since the 1962 revision to the United States Internal Revenue Code.

[17] The fully allocated cost is the cost of producing a unit of output including both direct material and labour costs and a fair proportion of overhead costs.

sion may be based on quite different considerations than production decisions in a non-arm's length transaction. Even if incremental production costs or the market price in Canada were to fall below the price being charged to the subsidiary, there is no assurance that procurement would be shifted to Canada. To the extent that sales to the subsidiary made some contribution to overhead, it could still be to the parent's advantage to continue to supply the subsidiary.

This analysis raises three important points for public policy. Firstly, a decision regarding the location of production based on incremental cost considerations is short-run in nature. Far more critical is the longer run decision about future expansion and the location of new capital investment. It is at this point that the Canadian authorities should be especially concerned about procurement by foreign controlled companies, particularly since the economic life of capital equipment can be quite long in some industries. Secondly, if an industry is oligopolistic in nature, the long run may never come, since the competitive pressures which would normally force a firm to locate production in the lowest cost jurisdiction would not exist. To overcome these obstacles, government intervention may be necessary. Lastly, it may also be necessary for the government to intervene to overcome non-economic biases which a parent company may have for location in its home jurisdiction.

Before leaving consideration of incremental costs, it should be noted that a subsidiary's feeling of "freedom" to purchase from lowest cost sources may, in some cases, simply reflect the use by the parent company of a monitoring system over its own production costs. A number of parent companies use "market target pricing" in intra-corporate transactions as a method of monitoring their own performance. The subsidiary is urged to search out lowest cost sources so that the parent can keep a check on its own production costs and those of other subsidiaries supplying the goods in question. If the subsidiary discovers a lower cost source of supply, the parent may lower its own price, depending upon where it wishes to show profits. If it decides to lower its price, the parent can theoretically go down to incremental cost (provided he can use existing capacity and cannot obtain a higher price selling in the open market). It follows therefore that the subsidiary may under such a system be free to search for lowest cost sources, but it is unlikely that local prices will ever be lower than the parent's incremental costs in the short run.

OTHER FACTORS

Business considerations such as quality control, reliability of supply, timing of deliveries, industrial security—a desire to protect know-how or patents, for example—"normal commercial preferences" and the maintenance of market power may also lead to greater imports from parents and affiliates.

IMPORTS FROM NON-AFFILIATED COMPANIES

There are two possible explanations for the greater import orientation of foreign than Canadian controlled firms in arm's length dealings:

(i) Where the parent company is *not* manufacturing the product or component itself, but purchasing it from an independent supplier, it will tend to buy for the subsidiary as well in order to take advantage of bulk purchasing to lower the unit price. This is conditional on the unit price—plus transportation, tariff, and other costs—being lower than the cost to the subsidiary of procurement in Canada. Provided tariff and transportation costs in shipping from Canada to the parent company were not prohibitive, lower Canadian costs could, in fact, lead to a shift in procurement to Canada.

(ii) The greater import orientation of foreign controlled firms may result from the foreign subsidiaries having wider knowledge through their parents of foreign sources of supply than their Canadian counterparts in most cases. The fact that there may be additional costs involved for the foreign controlled firm in getting information on the availability and adequacy (e.g., testing, etc.) of Canadian products must be recognized as a problem in pursuing greater procurement in Canada.

NON-ECONOMIC FACTORS

In addition to the economic considerations discussed above, there may be some non-economic factors leading to greater imports on the part of foreign controlled firms:

(i) Lethargy and inertia may prevent managers of foreign controlled firms from seeking out lower cost local sources of supply. However, there are indications that foreign controlled purchasers search for lower cost sources of local supply. It appears that Canadian suppliers are not always sufficiently aggressive in making their capabilities known to foreign controlled firms.

(ii) The decision to move production to Canada or switch from a foreign to a Canadian supplier affects local employment in the foreign country. There is evidence that labour unions can and have put effective pressure on foreign companies to keep jobs in the home country.

(iii) The United States balance of payments programme may have played a role in increasing subsidiary imports from parents and

other foreign suppliers. The United States Administration has urged parent companies to export more and import less from their affiliates abroad, but it is difficult to determine whether this "jaw-boning" has had any impact on the operations of subsidiaries in Canada.

The United States Congress recently opposed legislation to grant tax concessions to export-oriented "Domestic International Sales Corporations". This measure could give a United States parent company an additional incentive to have its Canadian subsidiary purchase its requirements from an affiliated DISC in the United States, rather than from an alternative source, and lead to the closing of the Canadian subsidiary or reduction of its output, with the Canadian market being supplied through exports from the United States. This is less likely if the investment in Canadian production facilities is relatively recent and large. The legislation could also give a non-affiliated DISC a competitive advantage over an arm's length supplier in Canada.

(iv) The procurement policies of subsidiaries and Canadian controlled firms are also affected by licensing arrangements arbitrarily specifying types and/or sources of materials and equipment to be used under licences.[18] Table 43 below contains an examination of 159 proposed arm's length licensing agreements that mentioned the question of procurement. While these proposed agreements were not between affiliated companies, the pattern indicated is unlikely to differ significantly in the case of affiliated companies when formal licensing arrangements are used. Of the 159 agreements examined, 123, or 77 per cent, contained no restrictions on procurement; the balance (23 per cent) stipulated some type of limitation on purchases, e.g., of raw materials (3 per cent); of components (12 per cent); and of machinery (6 per cent). While tied procurement as a result of licensing seems to be less pronounced than restrictions on exports, it is sufficiently prevalent to suggest that the Canadian authorities should consider examining licensing arrangements with a view to eliminating or reducing these restrictions on procurement.

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[18] As pointed out above, this type of tied purchasing of materials or components can be a convenient way for the parent to extract full or abnormal benefits and to vary repatriation of profits with the ability to pay, i.e., repatriation will vary with the volume and use that the market makes of the licensed product. This, of course, is a form of price discrimination; in lieu of charging different prices to different purchasers of the equipment, a higher price can be put on the use of the tied component or material. This technique effectively precludes a more efficient producer of the component from entering the market. This type of tied relationship via licensing is less necessary (and less likely to be found) in a parent-subsidiary relationship than in an arm's length transaction because the parent has other techniques of repatriating profits.

TABLE 43

PROCUREMENT RESTRICTIONS UNDER PROPOSED LICENSING ARRANGEMENTS*

1965–1969

	Number	Per Cent
No Procurement Restrictions	123	77
Required Procurement of Raw Materials	5	3
Components	20	12
Machinery	9	6
Procurement only if N/A in Canada	2	2
Total	159	100

* Source: Department of Industry, Trade and Commerce.

(v) One last non-economic factor should be mentioned. Whereas in the United States there is a tendency not to purchase a non-United States product, in Canada there is in many cases an opposite tendency. A Canadian purchaser is more likely to regard a Canadian-made product as being of inferior quality or performance. The extent to which this psychology transmits itself to the purchasing policies of subsidiaries is not known, but it could be a factor of some significance.

In summary, it appears that there are a number of reasons which help explain the high import propensity of foreign controlled firms and which help to reconcile this propensity with such freedom as subsidiaries may have to import from lowest cost sources.

It is unlikely that the market price of supplies in Canada (which tends to be the United States price, plus transportation and tariff) will be below the incremental cost of production in the parent company. In the case of arm's length transactions, bulk buying with the parent will often tend to reduce foreign prices below Canadian prices. It is also likely that the subsidiary is more aware of foreign sources than its Canadian counterpart. The feeling of Canadian managers of subsidiaries that they are free to import from lowest cost sources may in some cases be related to the use of "market target pricing" by parents and affiliates.

It should be borne in mind that:

(i) Purchasing decisions made on the basis of incremental cost considerations are short-run decisions. Unless there are non-economic factors which favour location in the parent's home market, in the longer run, the parent should expand or locate new production where it is most economic, or buy at arm's length if it is cheaper. The speed with which this occurs will depend upon the competitive pressures in the industry and the economic life of the investment.

(ii) Where purchases are being made at arm's length by the parent company, there is greater opportunity for sourcing in Canada if Canadian costs are competitive.

(iii) While some imports by subsidiaries appear to be based on non-economic factors, it is impossible to quantify their extent.

(iv) It should be recognized that there may be additional costs for a subsidiary in switching procurement to Canada, such as the costs of searching for alternative sources and costs of testing new products or components.

The policy implications of these conclusions are considered below.

ECONOMIC IMPACT OF HIGH IMPORT PROPENSITIES ON CANADA

Thus far it has been shown that foreign controlled companies import a significant proportion of their purchases; that the bulk of these imports come from the country of the parent and, indeed, parents and affiliates; that purchases are concentrated in sectors where foreign parent companies have dominant export interests; that foreign controlled companies are more import oriented than Canadian controlled companies; that United States subsidiaries in Canada are more import-oriented than United States subsidiaries in other countries; that this behaviour probably is economic and rational from the parent company's point of view, since purchasing from incremental production probably leads to greater profits for the entire operation and reduces investment risk. These findings are not inconsistent with the freedom of the Canadian subsidiary to buy from lowest cost sources, although there is evidence that some imports result from the operation of non-economic factors.

The question arises as to what the impact of this import-oriented behaviour is on Canada. Before considering this question, it is important to emphasize that Canada will probably always import a significant proportion of its consumption because of the comparative cost advantages abroad for many goods. Self-sufficiency, therefore, is not a feasible goal.

However, high levels of imports by foreign controlled companies can involve costs for the Canadian economy (even when this behaviour is rational from the point of view of the parent firm):

(i) High levels of imports by foreign controlled firms have probably contributed to the relatively slow development of manufacturing in Canada, including the Canadian supplier industries. It is difficult, if not impossible, for a Canadian supplier to sell to a Canadian subsidiary if it is competing against the incremental costs of production of a foreign parent company. The savings realized by the parent from internal sources of supply as a result of low in-

cremental costs of production are not necessarily reflected in the price paid either by the Canadian subsidiary or Canadian purchasers of the finished goods involved. This truncation in turn reduces the level of economic activity in Canada, employment opportunities (especially for skilled labour) and tax revenues. Canada is also denied other benefits of procurement activities, such as the achievement of economies of scale and the spill-over benefits from the association of a foreign controlled purchaser and a Canadian supplier. However, it should be remembered that procurement abroad may be the most efficient source of supply, particularly in the short run, and policies adopted to increase procurement in Canada must take this into account.

(ii) Procurement practices of parents and subsidiaries within a vertically integrated structure tend to keep out the potentially efficient Canadian supplier, who can enter the industry only by vertically integrating himself. This barrier to entry, when based on considerations other than economic efficiency, tends to support higher prices in the industry.

(iii) Sourcing through the parent represents yet another management decision that is probably made abroad on the basis of less information about potential Canadian sources than if the decision were made by a Canadian controlled firm.

It must also be recalled that the direct investment package may involve a tying of inputs other than those particularly required. In addition, limitations on the ability of subsidiaries to purchase from lowest cost sources of supply exist in a number of cases. Such limitations reduce the welfare of both the sudsidiary and the Canadian economy and are a legitimate concern of the Canadian government.

Of particular importance is the fact that the benefits of affiliation in the field of procurement, resulting from purchases from the parent company or the parent supplier which reduce costs and increase the competitiveness of the Canadian subsidiary, may not be passed on to the Canadian market. Whether this occurs is, of course, mainly related to the competitive climate in Canada. In some cases, the Canadian tariff and the high degree of concentration in the foreign controlled sectors probably lead to the benefits accruing mainly to the foreign operation through the higher prices it is able to charge in the Canadian market.

PROCUREMENT OF SERVICES

Very little information is available on the procurement of services by foreign controlled subsidiaries. To what extent are they purchasing management, engineering, accounting, advertising, and other services abroad? To

what extent do they use foreign controlled services in Canada? For example, is there a tendency for United States controlled manufacturing subsidiaries to employ the Canadian affiliates of advertising agencies used by their parent companies in the United States? These question are important because of the impact services can have on Canadian economic development and the formation of Canadian identity. Engineering services, for example, have a "multiplier effect" that can be quite dramatic—an engineering contract can generate ten or twenty times the volume of business of the contract itself and engineering firms design for the use of the technology and equipment they know best. Advertising can exert a profound influence on the lifestyle of the Canadian people through their impact on standards of taste, and the nature and composition of consumer demand.

Table 44, based on CALURA data, shows payments to non-residents for certain business services (excluding dividend and interest payments) by degree of non-resident ownership. Corporations 95 to 100 per cent foreign owned (40 per cent of total corporations making payments to non-residents) account for about half of all such payments to non-residents. Corporations 50 to 100 per cent foreign owned (about 54 per cent of corporations making payments abroad) account for about three-quarters of all payments. There thus appears to be a general correlation between the degree of foreign ownership and payments to non-residents.

The largest payments in 1964 were for management fees ($72 million) followed by royalties (patents, trademarks, etc.—$69 million), professional services (engineering, architecture, legal, accounting, etc.—$51 million), rent (mainly on equipment—$49 million) and research and development ($34 million). It is impossible to determine from the available data whether this structure of payments accurately reflects deficiencies in Canadian capabilities and services rendered, efficiencies that are achieved by a subsidiary acquiring services from the same source as the parent, or simply reflects more advantageous methods of transferring profits.

The 1966 CALURA report provides information on payments for services to non-residents, but is not subdivided by degree of foreign ownership or between foreign and Canadian controlled companies. In general, it shows that payments to non-residents, with the possible exception of engineering fees, parallel the ownership structure of the Canadian corporate community, with those industrial sectors which are predominantly foreign owned paying more to non-resident than do those industrial sectors which are Canadian owned.

There is no general statistical information on the use of foreign controlled service subsidiaries in Canada by foreign controlled goods-producing subsidiaries.

To illustrate the nature of the problems faced by Canadian service industries, additional information was obtained on the use of advertising services in Canada

TABLE 44

PAYMENTS TO NON-RESIDENTS FOR CERTAIN BUSINESS SERVICES BY DEGREE OF NON-RESIDENT OWNERSHIP, 1962–1964*

($ thousands)

Type of Payment		Degree of Non-Resident Ownership: Less than 5% $	%	5.0%–49.9% $	%	50.0%–94.9% $	%	95.0%–100.0% $	%	Total $	%
Rent (mainly on equipment)	1962	5,136	13	19,330	49	7,002	18	8,073	20	39,541	100
	1963	2,412	6	23,861	54	7,261	17	10,483	23	44,017	100
	1964	4,109	8	21,614	44	12,126	25	11,261	23	49,110	100
Royalties (for patents, trade-marks, industrial designs, etc.)	1962	7,807	15	6,790	13	7,392	14	30,519	58	52,508	100
	1963	10,002	16	4,082	7	9,256	15	38,008	62	61,348	100
	1964	10,675	15	5,905	9	12,102	17	40,724	59	69,406	100
Franchises	1962	4,348	18	1,567	6	2,118	9	16,451	67	24,484	100
	1963	5,284	19	1,291	5	4,546	16	16,536	60	27,657	100
	1964	6,061	20	1,291	4	7,479	25	15,119	51	29,950	100
Advertising	1962	5,207	22	1,873	8	2,538	11	13,918	59	23,536	100
	1963	3,345	15	2,102	10	1,746	8	14,560	67	21,753	100
	1964	3,697	16	1,870	8	2,595	11	14,939	65	23,101	100
Research and product development	1962	1,622	5	1,766	5	21,412	63	9,379	27	34,179	100
	1963	1,243	3	2,360	6	27,935	65	11,191	26	42,729	100
	1964	1,348	4	2,804	8	20,178	60	9,636	28	33,966	100
Insurance premiums	1962	..		..		..		..		16,649	100
	1963	..		..		..		..		14,346	100
	1964	2,310	17	673	5	2,383	18	7,918	60	13,284	100
Management fees, salaries, annuities	1962	..		..		..		..		71,996	100
	1963	..		..		..		..		65,009	100
	1964	1,767	2	5,106	7	16,161	23	48,597	68	71,631	100
Professional services, other	1962	5,170	10	6,663	14	12,731	26	24,712	50	49,276	100
	1963	3,399	7	10,721	23	8,461	18	23,351	51	45,932	100
	1964	4,244	8	8,429	17	16,486	32	21,849	43	51,008	100
Total	1962**	36,884	12	43,356	14	67,801	22	164,128	52	312,169	100
	1963	30,384	9	49,773	15	73,106	23	169,528	53	322,791	100
	1964	34,211	10	47,692	14	89,510	26	170,043	50	341,456	100

*SOURCE: CALURA 1964, Table 7.
**1962 ownership data incomplete (total payments short by $3,603,000).

Table 45 shows that the 13 United States controlled advertising agencies which are members of the Institute of Canadian Advertising accounted for 25 per cent of the membership and 31 per cent of the billings in 1968. The average size of billing of the foreign controlled firm in that year was $8.6 million, against $7.5 million for the Canadian owned firms. Since 1960, the foreign owned firms have been growing faster than Canadian owned

firms. In ten years, if these comparative rates of growth are maintained, the foreign owned firms will dominate the Canadian market. Unfortunately, this table does not provide the information on the nationality of clients by ownership of the agencies.

TABLE 45

MEMBERSHIP AND BILLINGS OF THE INSTITUTE OF CANADIAN ADVERTISING*

(numbers and millions of dollars)

	1950	1955	1960	1965	1968
			(numbers)		
Total number of agency members	33	49	45	47	53
Canadian members	30	42	36	35	40
Total number of United States agency members	3	7	9	12	13
			(millions)		
Estimated total member billings	72	135	252	345	412
Canadian billings	63 (88%)	116 (86%)	207 (82%)	262 (76%)	299 (73%)
Estimated total United States member billings	9 (12%)	19 (14%)	45 (18%)	83 (24%)	113 (27%)
Average (Canadian) billings	2.1	2.75	5.8	7.5	7.5
Average (USA) billings	3.0	2.75	4.9	6.9	8.6

* Source: Based on the Report of the Special Senate Committee on Mass Media, Vol. II, Table 43.

An examination of the nationality of accounts of the top 10 United States owned or controlled advertising agencies shows that 62 per cent of their accounts are from United States subsidiaries and 38 per cent from Canadian owned and controlled companies. The situation is reversed for the Canadian owned agencies. Sixty-seven per cent of the clients of the top 10 Canadian owned agencies are Canadian controlled companies and only 33 per cent are United States subsidiaries.

An examination of the ownership of the advertising agencies used by 48 of Canada's larger corporations shows a similar tendency. Of these 48 large corporations, 22 were Canadian controlled, 14 were United States controlled and 12 were controlled in countries other than Canada or the United States. Of the 20 advertising agencies employed by the 22 Canadian owned companies, 12, or 60 per cent, were Canadian, 7, or 35 per cent of the total, were American, and 1, or 5 per cent of the total, was of unknown ownership. Of the 18 advertising agencies used by the 14 United States controlled companies, 8 (44 per cent of the total) were Canadian, 9 (50 per cent of the total) were United States controlled and 1 (6 per cent of the total) was of unknown ownership. Of the 16 advertising agencies

used by the 12 companies of other foreign ownership, 9 (56 per cent of the total) were Canadian and 7 (44 per cent of the total) were United States owned.

Evidence given to the recent Senate inquiry into the mass media indicates that some United States subsidiaries are repatriating their advertising function to the United States. There have also been examples of Canadian agencies losing a client that has been taken over by a United States firm to the agency serving the parent company.

CONCLUSIONS

The major conclusions that emerge from this examination of the impact of foreign control on the procurement policies and import practices of subsidiaries in Canada are the following:

(i) Foreign controlled companies (including the automotive sector) are importing a large and growing proportion of their purchases of goods and services, e.g., foreign controlled "reporting subsidiaries" import about one-third of their total purchases. Excluding the automotive sector, imports as a proportion of purchases are stable at about 25 per cent.

(ii) Foreign controlled companies tend to source their imports in the country of the parent companies. Because of the high degree of United States control of Canadian industry, this results in substantial purchasing in the United States; "reporting subsidiaries" controlled in the United States purchase about ninety per cent of their imports in the United States.

(iii) Not only do foreign controlled companies tend to import from the country of their parent companies, they are sourcing a large and growing proportion of their imports from parents and affiliated companies. About three-quarters of the imports of "reporting subsidiaries" come from affiliated companies. In 1969, approximately thirty per cent of total Canadian imports were in the form of intra-corporate transactions.

(iv) Imports tend to be concentrated in manufacturing sectors where there is a high degree of United States direct investment and where the United States appears to have a continuing dynamic advantage based on high levels of expenditure for research and product development.

(v) Foreign controlled companies are more import-oriented than Canadian controlled companies and imports as a proportion of sales are greater for United States subsidiaries in Canada than United States subsidiaries in other countries.

The greater import orientation of foreign controlled firms raises the question whether they are purchasing from lowest cost sources. In most cases, this greater import orientation is probably based on sound business judgment. As pointed out above, it is the parent that tends to develop a distinctive product and the appropriate components and supporting services for its production. If these components and services are produced internally by the firm, it will be difficult to duplicate them in the arm's length market in Canada and costly to create similar capacities in Canada. Secondly, there is likely to be a cost advantage and convenience in producing in the parent's plant and exporting to subsidiaries, due to the probable location of large-scale operations in that plant. Canadian costs would likely be higher unless production were rationalized between the Canadian subsidiary and the parent company.

Even if costs could be matched, comparable and reliable components for a rapidly changing product of a highly distinctive nature would be difficult to duplicate. The distinctiveness may be based on a sophisticated technology which is not easily reproduced outside the corporation without divulging commercial or industrial secrets. In any event, where the parents and the Canadian subsidiary are producing like or similar products it is unlikely that the market price of supplies in Canada (which tends to be the United States price, plus transportation and tariff) will be below the incremental cost of production in the parent company or, for that matter, below the fully allocated cost or the alternative market price at which the parent could sell the components at arm's length to other buyers.

Despite the fact that the high level of imports from the parent company appears generally to be based on sound business considerations, there are a number of issues which raise concerns for public policy and justify consideration being given to government intervention. It is known, for example, that arbitrary restrictions on procurement exist in a number of cases. Furthermore, it is important to bear in mind that purchasing decisions made on the basis of incremental cost considerations are short-run decisions, based on the advantages of making the fullest possible use of productive capacity already in place. In the longer run, it is to the parent's advantage as a general rule to expand production where it is most economic or buy at arm's length if it is cheaper. This might not occur, however, in industries where competitive pressures are not very great (for example, world-wide oligopolies) or where non-economic biases induce the parent to produce or purchase from suppliers in the home market. In these circumstances, governmental pressures might be necessary to induce a parent company to locate an efficient scale plant in Canada if it can be established that there are economic advantages —or at least no disadvantages—in doing so.

There are additional reasons which help to explain the import orientation of foreign controlled firms. Where the parent company is buying at arm's length, bulk buying, both for its needs and for those subsidiaries, will tend to reduce foreign prices below Canadian prices. The parent also normally

bears the costs of any testing required for the product. It is also probable that the foreign controlled subsidiary is more aware of foreign sources than its Canadian counterpart.

While this large volume of imports and purchases from parents and affiliates may make good business sense from the point of view of the particular company, and can benefit the economy as a whole (if the lower costs are passed on to the market-place), it can also have a number of serious adverse implications for Canada:

(i) A high level of procurement abroad can retard the development of the manufacturing and service sectors in Canada.

(ii) The large and growing volume of Canadian imports accounted for by intra-corporate transactions introduces an increasing degree of rigidity into the structure of trade and the balance of payments, making them less responsive to market forces and in some cases to general government policies, such as a policy of varying the level of imports for balance of payments reasons, or of diversifying sources of imports.

(iii) A relatively high proportion of imports is in technologically intensive sectors. The United States appears to enjoy a continuing advantage in these areas, based on the rapid development of distinctive products. This suggests that United States parent companies will have a bias for expanding their home base where the centre of innovation is located. It further suggests that Canada will tend to be perpetually "behind" unless the government intervenes to reverse the situation in some sectors of particular importance to Canada. This would probably involve rationalization of production with the parent.

(iv) The existence of a high degree of vertical integration in the procurement process involving a Canadian subsidiary and its foreign parent constitutes a significant barrier to entry, which makes it difficult for an independent Canadian supplier to enter the market for the particular component or end product.

(v) Large volumes of inter-affiliate trade increase the possibilities for transfer price activities detrimental to the Canadian Treasury.

POLICY ALTERNATIVES

There thus appears to be an argument for government intervention to obtain greater procurement activity in Canada where short-run committed costs elsewhere are the reason for the failure to produce or procure in this country. In the longer run, there is a case for securing greater production and procurement in Canada where this is not being done because of business

considerations which do not maximize Canadian benefits and cost advantages. To achieve this objective, four alternative policy approaches are open to the government. These are:

(i) the introduction of mandatory rules on Canadian participation;

(ii) mandatory procurement in Canada or a certain proportion of purchases;

(iii) the use of a review process to scrutinize procurement practices; and

(iv) improved information and testing services and procurement data.

While there are short-run reasons that tend to make the multinational enterprise reluctant to alter some of its procurement practices, which in part explains the need for some intervention by government, in the longer run the multinational enterprise will generally tend to purchase its requirements from the lowest cost source, particularly under the pressure of competition. This emphasizes the importance of general policy measures to improve the cost competitiveness of the Canadian economy.

MANDATORY CANADIAN PARTICIPATION: OWNERSHIP RULES

There is no assurance that mandatory Canadian participation, such as requiring a foreign controlled firm to sell 51 per cent of its voting shares to Canadians, would lead to greater procurement in Canada. While Canadian controlled firms generally are less import-oriented than their foreign controlled counterparts, Canadian participation is unlikely to increase procurement in Canada substantially because the links to parents and affiliates that lead to greater imports by foreign controlled firms would continue to exist. It could be argued that Canadian participation could, however, have some impact on the level of transfer prices (see Chapter Thirteen).

Mandatory Canadian participation would also introduce an added degree of protectionism into the Canadian economy by making it more difficult and costly for a foreigner to establish in Canada. This could be counterbalanced in certain instances by reducing trade barriers in such cases.

PROCUREMENT RULES

Another alternative—one which would ensure high levels of procurement in Canada—would be the introduction of an arbitrary procurement rule, such as requiring that all foreign controlled companies make a fixed percentage of their purchases in Canada. Leaving aside for the moment the discriminatory character of this approach, the high degree of protectionism involved could be quite costly to the Canadian economy. This approach also ignores the fact that there can be real cost benefits in vertical integration (which leads to the question whether government policy should seek to en-

sure that these benefits are passed on to the Canadian economy). However, consideration could be given to the feasibility of developing such rules for individual sectors over time.

SELECTIVE APPROACH: A REVIEW PROCESS

One of the factors which a review process could take into account is a firm's procurement policy. In those cases where procurement from the parent is in the best interests of the firm, but not necessarily in the best interests of the long-term economic development of Canada, a review process could bargain for the location of new productive facilities in Canada in cases where this is economic. The new production facilities in Canada could serve, for example, the Canadian and European markets, with the MNE acting as a channel for Canadian exports to European subsidiaries. A review process could be the least protectionist, and hence the least costly, of the possible policy alternatives because of its flexibility. It could, in fact, contribute to the efficiency of the Canadian economy. It could seek to reverse procurement decisions that are based on arbitrary and non-economic factors, which contribute neither to the welfare of the particular Canadian firm nor to the country as a whole. The extent to which the review process could secure this type of investment for Canada would depend upon many factors, including the costs of production, access to foreign markets, the importance of the Canadian market and transportation costs. Part V contains a fuller discussion of the problems, prospects and implications of greater "rationalization" of this type.

In those cases where the parent is purchasing at arm's length and it does not make economic sense for the Canadian subsidiary to produce the product or component itself, the review process could seek to ensure that Canadian suppliers have an opportunity to bid for the supply contract.

OTHER POLICY ELEMENTS

In addition to the review process and the other policy options discussed in this study, a number of other policy options could be considered to foster greater procurement activity in Canada or increase the benefits of foreign procurement in Canada.

Information and Testing Service

Since foreign controlled companies have easy access to a wide range of tested and approved products through parents and affiliates, the government could consider supporting the establishment of an information and testing service, either in the public or the private sector, that is open to both Canadian and foreign companies. This service could collect and disseminate information on Canadian industrial capabilities and in this

respect might be regarded as a domestic counterpart to the Trade Commissioner Service. It could also provide a testing service to help defray the cost of testing products (including parts and components) available in Canada. Some European countries are moving in this direction in the field of electronic components (Britain, Germany and France).

A service of this nature should strengthen procurement in Canada, particularly by foreign controlled firms, by decreasing the tendency on the part of the parent company to do the testing and purchasing for subsidiaries.

General Economic Environment

It has already been pointed out that pricing decisions are in many cases made on the basis of United States price, plus transportation and tariff. This effectively means that many of the benefits of procuring through the vertically integrated foreign controlled company are not taken in Canada and passed on to the consumer. One way of getting more of the benefits would be to increase domestic competitive pressures, either from domestic or international sources, in an effort to reduce costs in Canada and improve the competitive position of Canadian suppliers. This could involve tariff reductions in certain cases or the application of a more vigorous domestic competition policy.

Better Information

Lastly, it is important to underline the necessity of obtaining much better information on the procurement policies and practices of foreign controlled subsidiaries relative to Canadian controlled companies. This question is considered more fully later in this study.

Chapter Twelve

THE IMPACT OF FOREIGN DIRECT INVESTMENT ON DOMESTIC COMPETITION

INTRODUCTION

In an economy that relies on the market-place for efficient allocation of resources, the competitiveness of the environment is of considerable importance. The market helps decide what goods and services are made available. It has an important influence on the efficiency with which these goods and services are produced and on the ultimate distribution of the proceeds between producers and users. The more effective the competitive stimulus in a market economy, the more likely that the needs of consumers and users are filled, the more efficient the production processes and the fairer the prices. Inadequate competition tends to lead to relatively higher prices, less efficient production, less innovation and a poorer response to the needs of consumers.

A high degree of concentration in an industry—one in which a small number of firms account for a large proportion of the sales of the industry—tends to result in inadequate competition, with all of the adverse consequences outlined above.

An analysis of the relationship between foreign ownership[19] in Canada and market structure brings out three factors that are of particular relevance to the degree of competitiveness existing in the manufacturing section of the Canadian economy.

In the first place, foreign owned firms are typically larger than Canadian owned firms. While this could be because they are located in industries in which all firms are large, the evidence shows that it is accounted for mainly by the fact that foreign owned firms tend to be among the largest firms in any given industry.

Secondly, there is a significant relationship between foreign ownership and the degree of market competition. Industries which are more than

[19] Although the notion of "control" is used much more frequently elsewhere in this study, the data and studies reported on here have all used "ownership" statistics. To avoid any misrepresentation of the studies, the concept of "ownership" is used in this section. For practical purposes, it would not appear to change any of the analysis if this were translated as "control".

half foreign owned are dominated by a small number of firms. By contrast, Canadian controlled industries tend to have much more competitive market structures.

There is, thirdly, a close correlation between concentration in Canadian industries and concentration in United States industries. The more oligopolistic industries (those which are dominated by relatively few firms) in the United States are also the more oligopolistic in Canada—although the degree of concentration in the Canadian industry is typically much higher. Each of these points is examined in more detail below.

THE COMPARATIVE SIZE OF CANADIAN AND FOREIGN OWNED FIRMS

Calculations from CALURA data for 1968 show that sales and assets of all foreign owned firms[20] averaged respectively $6.34 million and $7.81 million. The comparable values for Canadian owned firms were $1.62 million and $2.45 million. The same information for all manufacturing firms only shows foreign owned firms sales of $12.11 million and assets of $11.44 million, whereas Canadian owned manufacturing firms had average sales of $3.03 million and assets of $2.58 million. While it might be expected that many of the smaller enterprises would be domestically owned, it should be pointed out that these data exclude the smallest companies entirely—corporations with sales of less than $500,000 and assets of less than $250,000.

In addition to being larger, foreign owned manufacturing firms are more capital intensive. Capital intensity constitutes a barrier to the entry of new firms by virtue of the large amounts of capital which have to be invested and the risk which that involves for a new entrant. A study[21] of this characteristic revealed that foreign owned firms accounted for only thirty per cent of Canadian manufacturing employment but sixty per cent of the book value of the corporate assets. This is probably largely explained by the fact that foreign owned firms are most often located in industries with capital intensive production. It may also be partly explained by the fact that these firms use technology developed for their home markets, where costs of labour are high and other factors, such as capital, are relatively attractive. When investing in Canada, these firms generally locate in the higher wage regions of Canada.

The greater size of foreign owned firms is not due so much to the large size of firms typically to be found in the kind of industries in which they tend to be concentrated as to the fact that foreign owned firms usually are relatively larger than Canadian owned firms in any given industry. One repre-

[20] These calculations are based on the CALURA formula, which records firms with more than 50 per cent of voting rights owned by foreigners as non-resident owned.

[21] D. Michael Ray, Regional Aspects of Foreign Ownership in Canada; Report to the Task Force on Foreign Ownership and the Structure of Canadian Industry, 1967.

sentative study[22] concluded that the larger size of foreign owned firms could be accounted for only to the extent of thirty per cent by the degree to which these foreign owned firms formed part of industries that usually were made up of companies of substantial size. The study estimated that the remaining seventy per cent could be accounted for by the fact that in any given industry —regardless of its nature—foreign owned firms are usually larger than those owned by Canadians. The study sample also showed that three times more foreign owned firms were among the eight largest firms in their industries than those among the smaller firms in their industries.

THE RELATIONSHIP BETWEEN FOREIGN OWNERSHIP AND CONCENTRATION, TAKEOVERS AND PRODUCT DIFFERENTIATION

High levels of concentration tend to lead to less effective competition, higher prices and lower levels of production and consumption than would prevail under conditions of more vigorous competition among many firms. This can lead to a redistribution of income from the users of a product to the owners of the firm as a result of the higher profits earned by the latter. It can also lead to inefficient production or a reduced incentive for dynamic innovation.

Previous studies[23] have indicated that the percentage of output of any given industry accounted for by the foreign owned firms within it, and the extent to which the number of firms within that industry is concentrated, are not completely correlated. That is, the degree of concentration of industry and the level of foreign ownership do not vary directly with one another. It does not necessarily follow, for example, that as foreign ownership increases so does the degree of concentration. However, if Canadian industries are divided into those which are dominated by foreign owned firms (that is, those industries in which foreign owned firms account for more than half of total industry employment) and those dominated by Canadian owned firms, it appears that those industries which are foreign dominated also have substantially more corporate concentration than those dominated by Canadian owned firms.[24]

The evidence also shows that the industries in Canada which are most highly concentrated tend to be those which are the most concentrated in the United States. It would appear that United States firms in oligopolistic

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[22] Gideon Rosenbluth, *The Relationship Between Foreign Control and Concentration in Canadian Industry;* Canadian Journal of Economics, III (1970) 14.

[23] Gideon Rosenbluth and Max D. Stewart, *Concentration in Canadian Manufacturing and Mining Industries;* Background Study to the *Interim Report on Competition Policy;* Economic Council of Canada.

[24] Concentration can be measured by several alternative criteria of firm size—employment, assets and sales are the most commonly used. Each has its own biasing or distorting effect. The use of employment to measure the relative size of different firms in an industry would tend to record a lower concentration than sales or assets measures if the larger firms are more capital intensive in their production methods.

United States markets have tended to expand into Canada more than those in less concentrated markets and that these foreign firms have succeeded in maintaining their market dominance in Canada.

Takeovers constitute a means of entry which tend to increase industrial concentration more than would the entry of a new firm. Foreign takeovers have constituted a larger part of total merger activity than have domestic mergers. Horizontal takeovers, which involve one firm acquiring another firm engaged in the same industry and activities, do on their face pose a greater likelihood of lessening competition more severely than vertical or conglomerate mergers, since they directly reduce the alternative supplies of a particular product.

A study covering the years 1951-61[25] found that non-United States foreign firms increased their control of Canadian industry and accounted for a relatively larger proportion of takeovers of Canadian firms during that period than either Canadian or United States firms. Horizontal takeovers were found to be the most frequent variety of takeovers in Canada in this period—and foreign firms (United States and others) accounted for relatively more of these mergers than did Canadian firms.

A further aspect of reduced competition and one particularly applicable to consumer products industries is the degree of artificial "product differentiation" between the output of the different producers. This form of non-price competition involves sellers trying to persuade consumers that their products are not perfect substitutes for one another, regardless of the physical or technical specifications being either identical or highly similar. Under such conditions, the consumer is often prepared to pay a higher price for one seller's product than for that of another. This permits sellers to "compete" without offering lower prices or products that are better in any real sense. It also erects barriers to the entry of new firms having to penetrate the market by altering the prevailing consumer preferences—an exercise which can involve both relatively high risk and high cost.

One study involving a sample of sixteen industries[26] revealed a close correlation between product differentiation and foreign control, with competition based on product differentiation being more prevalent or more intense in industries in which foreign control was high. This same study showed that the advantage of the large, multiplant company derived mainly from the economies in developing and maintaining product differentiation, rather than the economies of large-scale production. It is the large size of the firm, rather than the existence of several plants, that is important, making possible the substantial expenditures required to establish and maintain product differentiation in some industries—such as the development of distinguishing new characteristics in the automobile industry, the maintenance of extensive dealer networks in the case of gasoline distribution, or extensive

[25] Rosenbluth, *op. cit.*

[26] H. C. Eastman and S. Stykolt, *The Tariff and Competition in Canada;* Macmillan, Toronto, 1967, pp. 96-100.

advertising, promotion and marketing costs in the case of soap products. These are among the elements that go into the development of a "distinctive characteristic" of a particular brand or product. In Canada, many of the goods differentiated in this way come from foreign sources, either being imported from aboard or produced in Canada by a foreign owned subsidiary. In addition, the spill-over impact of the seller's efforts from adjacent United States markets—and the committed costs in the promotional campaign or in other distinguishing features—can be the basis of profitable extension of the markets of the seller through direct investment in Canada. Thus, these basic costs are spread over a larger sales volume than a new Canadian firm might be able to achieve in some industries. The direct entry of a foreign firm can capitalize on the spill-over image in the Canadian market and can extend the market dominance into Canada, so that the barriers to entry prevail in this economy as well and preserve the market position of the foreign investor. (Reliance on promotional materials and product characteristics developed for the home market is to be expected and helps accounts for the use of services from the parent or from the same source as the parent—or explains the centralizing of many of these activities in the parental head office.)

CORRELATION BETWEEN INDUSTRY CONCENTRATION IN CANADA AND THE UNITED STATES

The suggestion that foreign investment generally constitutes an extension of market dominance by foreign firms into the Canadian market-place is supported not only by the evidence reported earlier on the relationship between foreign ownership and concentration, but also by further evidence linking concentration in Canadian industry to that existing in the United States market—the country from which most foreign investment in Canada comes.

The most highly concentrated industries in Canada tend to be those which are the most concentrated in the United States. In fact, this correlation between concentration in Canadian and United States manufacturing is high.[27]

Canadian manufacturing industries are much more highly concentrated than corresponding United States industries. Thirty-four per cent of Canadian manufacturing shipments in 1964 came from industries in which eight or fewer firms accounted for eighty per cent of the total value of industry shipments.[28] Only 13.7 per cent of United States manufacturing shipments came from industries concentrated to that extent.

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[27] Stewart, *op. cit.*

[28] Concentration is traditionally measured by identifying the proportion of sales, assets or employment which the largest 8 firms and the largest 4 firms account for. The higher the proportion, the greater the concentration. An alternative approach is to measure the number of firms whose activities must be added to account for some percentage of the total activity of the industry—e.g., 80 per cent of sales, assets or employment.

The factors contributing to this high degree of concentration would seem to be the considerably smaller size of markets for manufactured products in Canada, so that only fewer firms of comparable size can exist in Canada and economies of scale which, in some industries, dictate the efficient plant size—although not necessarily the firm size.

Higher concentration in Canada could thus be a reflection of the dictates of the economies of production in the industry. The need to remain competitive with imports or to undertake efficient production to be competitive internationally could impose a size on Canadian operations which permits only few plants to operate. If the smaller market available to Canadian based operations (that is, the domestic market plus the potential export market) led to fewer firms all operating at efficient levels and subject to competition from imports, the resulting increase in concentration of Canadian production would make good economic sense. However, this is frequently not the reason for the relatively high concentration in Canadian industry. Instead, this high degree of concentration often results from the existence of a few foreign firms extending into Canada their market dominance based on product differentiation. Such a structure persists in this country—despite insufficient production in any firm or product line to achieve the economies of scale—partly because of product differentiation, and partly because of tariff protection—domestic and foreign—which limits export markets and protects domestic markets from import competition.

Despite being more concentrated than United States industries, Canadian manufacturing industries are not taking full advantage of economies of scale. This is frequently the result of the fact that these firms produce a larger than optimal range of products in a plant that is otherwise of optimal size. Since not all of the firms operating in the United States or elsewhere enter Canada, a greater degree of concentration results. The large product range leads to higher costs. In this situation, the degree of competition in the Canadian market-place between domestic companies and that provided by imports from abroad is apparently inadequate to compel domestic producers to rationalize their production by concentrating on the output of fewer goods in larger volume in order to achieve the economies of scale which that would permit. Canadian and foreign tariff barriers may each be a contributing factor in certain cases.

TARIFF PROTECTION AND COMPETITION

The degree of tariff protection for the final products of many secondary manufacturing industries in Canada permits them to exceed world production costs by significant margins, while taking advantage of the lower tariffs on materials and imported components. The Canadian tariff provides sufficient protection to a wide range of industries to enable them to compete in the domestic market even when they are less efficient than foreign producers.

To measure the impact of the Canadian tariff (and thus the degree of higher cost and perhaps the inefficiency it permits), it is necessary to make a distinction between the nominal tariff rate and the effective degree of protection that it actually provides. To determine the effective degree of protection, it is also necessary to consider the rate of duty on those things which go into the manufacture of the final product, and the value of those imported inputs in relation to the value of the final product.[29]

For instance, assume that there were no tariff on raw cotton or on cotton yarn, and assume also that the price of raw cotton is 50 cents per pound landed in Canada, and the price of imported yarn landed in Canada is \$1.00 per pound. Canadian manufacturers of yarn would have to sell at \$1.00 per pound to remain competitive with imported yarn, i.e., they could add only 50 cents per pound in value and remain competitive. In fact, the rate of duty on imported yarn is generally 17½ per cent, whereas the rate of duty on raw cotton is nil. This enables Canadian producers, in this example, to charge a price of up to \$1.17½ per pound. As they obtain the raw cotton at 50 cents, this extra 17½ cents which they can add to their selling price relates only to their spinning activity, i.e., they are able to add 67½ cents of value, not just 50 cents, and still remain competitive. Thus the tariff affords an effective rate of protection of 35 per cent. This buffer to import competition may permit the firms behind the tariff wall to avoid taking full advantage of economies of scale while still being able to compete against imports.

The foreign firms in Canada tend to turn out a larger than optimal range of products—often the full product line of the parent—in relatively small volume. Frequently this output is undertaken in a plant that is otherwise of optimal size for production of fewer lines. This phenomenon is frequently referred to as the "miniature replica effect" of foreign ownership. The unit production costs of these firms, which often use the production technology geared to the larger (and more efficient) output of the parent plants, are usually higher as a result of the smaller output of individual products. The smaller output may also be partly attributable to the entry of an excessive number of producers into Canada as each firm seeks a share of the protected Canadian market. In the absence of strong domestic competition (as a result of the concentration of companies and product differentiation), and in the absence of strong import competition (as a result of tariff protection), there is a lack of pressure on foreign owned subsidiaries in a number of Canadian industries and their Canadian counterparts to fully achieve the economies of scale offered by the Canadian market (to say nothing of the economies offered by serving other markets as well).

Smaller production runs, miniature replica operations and more numerous firms in a given industry than may be most efficient for a market the size

[29] The formula normally used in calculating the effective rate of protection (E) is as follows: value added in domestic production (A), *minus* the value which would have been added in domestic production in the event that there were no tariff on the finished product (B), *divided by* the value which would have been added in domestic production in the event that there were no tariff on the finished product. That is, E equals $\frac{A-B}{B}$.

of Canada, all tend to result in unit costs for Canadian manufacturers that are higher than would be the case if their production was more rationalized to provide for the output of fewer goods in larger volume. Why then do the firms not reduce their product line? The fact that competition from domestic and import sources is not such as to require them to do so in order to survive is only a partial explanation. If costs could be reduced, why would the firm find it rational to continue this pattern?

It is true that Canadian subsidiaries could reduce physical production costs in some cases by producing a more limited range of goods in greater volume. However, foreign firms in particular tend to manufacture and market their full product line in Canada because of other cost considerations that are related primarily to tariffs and transportation. Despite the higher unit costs of production involved, they often find it more profitable to produce their full line of products in Canada to maintain their market position, and in some cases the firm may be attempting in the shorter run to fully exploit the productive capacity of existing plants by turning out a wide range of products. If the cost considerations involving tariffs and transportation made it more profitable for the subsidiary to rationalize its operation by importing part of a company's line of products, while producing the remainder in Canada—either for sale in the domestic market alone or for export as well—the firm would likely do so.

Rationalization among competing subsidiaries in Canada is not likely to be too appealing to these foreign firms that have a full product line for which they can find a market in Canada. There is also the possibility, however, of rationalization of production between parent and subsidiary where the level of Canadian, and possibly also foreign, tariffs makes this a more profitable form of operation. If, for example, at least part of a firm's product line can be imported duty-free, the subsidiary might find it more profitable to import those goods from the parent company, while producing the remainder of the line in Canada. Canadian tariff policy has, on occasion, assisted foreign subsidiaries in Canada to achieve this form of rationalization by providing duty-free entry for supplementary models. An even more efficient form of rationalization from Canada's point of view may involve the Canadian subsidiary producing part of a company's line of products not only for sale in the Canadian market, but for export to some or all of the parent firm's markets in other countries. Such an arrangement may provide the opportunity for the Canadian subsidiary to achieve the maximum economies of scale. The feasibility of this form of rationalization may depend in part on the level of foreign duties. Canadian tariff policy has in the past also encouraged such a development by providing for a drawback of duty on imported products related to the volume of exports of Canadian goods in cases where the level of foreign tariffs permitted such a complementary exchange of goods between affiliated companies.

In considering this issue, it is important to take account of a factor that can distort the cost picture of Canadian subsidiaries. If the Canadian company

is required to carry a proportion of the parent firm's fixed overhead costs, such as those for research and development, this will raise the subsidiary's recorded costs per unit of output and reduce its reported profitability. However, these fully allocated per unit costs that the subsidiary is required to bear may not reflect the real profitability of the foreign investment because such overhead costs may have already been fully covered by sales in the parent firm's home market. The subsidiary's actual incremental cost of production, that is the cost of producing additional units after overhead expenses have been covered, would, therefore, be lower than the fully allocated costs assessed against the Canadian company.

Miniature replica

IMPLICATIONS

The evidence thus suggests that foreign investment can render Canadian industry less competitive by introducing greater concentration and product differentiation. This can restrict competition in Canada, particularly in cases where foreign entry is achieved through the takeover of a Canadian firm, or where the dominance of a foreign firm already in Canada is increased by such an acquisition. Concentration and product differentiation, combined with tariff protection and/or an unaggressive domestic competition policy, can lead to market structures and price levels which do not generate the most efficient production the Canadian market could support, nor a price level which that efficiency would permit. These cost factors also limit the opportunity for such goods to be marketed abroad.

The foreign firm may have an advantage over a Canadian counterpart of a kind that contributes to industrial efficiency in Canada. This may well permit such firms to dominate a Canadian manufacturing industry. The capacity of a foreign subsidiary to draw on a parent's technological innovation, engineering and management services, for example, offers a potential benefit to Canadian industrial efficiency—at least in the short-run—if these cost advantages are reflected in lower prices.

Similarly, the spreading of fixed costs over larger markets by foreign owned firms or MNE's can benefit Canada. The economies of large scale production might permit Canada to acquire various valuable inputs at a lower cost than could be achieved by indigenous production. The same result could flow from Canadian firms operating in a sufficiently large market.

For a few industries, the Canadian market is simply too small by itself to support the volume of output that would be required from just one plant of the minimum size necessary to achieve the economies possible from large scale production. In many other industries, however, the market is sufficiently large to permit the economies of scale to be realized. But these economies are not likely to be achieved in such industries, either, if the Canadian environment provides support for the continued existence of a substantial num-

ber of individual plants and firms, each producing a full range of products in relatively small volume. Foreign direct investment undertaken behind the shelter of high tariff walls contributes substantially to the development of this kind of structure in many manufacturing industries.

Even where there are economies already being achieved through the integration of Canadian production with a foreign firm, however, the question remains whether the benefits of these economies are being transmitted to the Canadian market. If a foreign firm (or Canadian firm) is under no pressure to do so, the savings could be taken in the form of increased profitability for the parent in one form or another. Where the competition for firms in Canada comes from import competition, Canadian prices will tend to the level of prices in the United States, plus transportation, plus tariff costs (assuming a United States producer is the one with the easiest access to the Canadian market). Savings from foreign investment which do not get passed on to the Canadian market-place in one form or another are of little or no benefit to Canada.

The advantage of the foreign firm may stem from marketing factors, rather than from economies of production or technology. Particularly in the case of United States based consumer product firms, the advantage may result from their capacity to transfer United States marketing patterns to Canada by producing a wide variety of styles or models of a given product using the parent's product designs, in some products making frequent (generally annual) design changes, or supporting a substantial advertising campaign and selling at prices which an independent Canadian firm could not match if it had to undertake similar expenditures. In this way, the advantage of spreading fixed costs is taken in the form of cost increasing, product differentiating techniques, rather than in price reducing, cost savings. This constitutes an advantage for the Canadian consumer only if he is genuinely benefited by the United States market demand patterns. Whatever advantages are to be gained by the Canadian consumer from such a marketing pattern could be enhanced by adoption of a more rationalized production system.

Even if the foreign owned subsidiary pays a pro-rated price for these inputs of product design and promotion, the large scale facilities and international operations of the parent firm reduce the cost below that which would have to be borne by an independent firm attempting to match such product proliferation, frequency of change, or distribution and marketing techniques. These techniques are, however, forms of intercorporate rivalry that constitute "product differentiation", which is often artificial in nature, and frequently do not result in real price competition. Where this pattern of demand and promotion becomes firmly entrenched, entry opportunities for other firms—Canadian or foreign—are significantly reduced.

The foreign firm might enjoy a degree of product differentiation which is based on advertising spill-over from the United States or other source, or

upon market power which is rooted in the effective domination of the distribution of a product or service. This form of advantage for the foreign firm similarly offers no real benefits to Canada and reduces the competitive forces in the Canadian industry involved.

Aside from these potential advantages enjoyed by a foreign firm, parental backing might provide easier access to capital from internal resources of the firm or from the financial markets in Canada or abroad. The benefit which this confers on a foreign firm also makes it more difficult for an independent Canadian firm to enter or compete effectively. Where this easier access to capital is not based on efficiency or economies of scale—or is based on efficiencies which are not passed on to the Canadian market—Canadian industrial efficiency is not enhanced by the foreign controlled operation.

Some of these problems are open to correction by domestic policies, particularly those involving competition and tariffs. In the case of domestic competition, the fact of foreign ownership complicates the application of Canadian policy. The problems arising out of jurisdictional complications and the difficulties of obtaining evidence of some offences for which documentation is located outside Canada, are discussed elsewhere in this study. Product differentiation rooted in the home market of the foreign firm which spills over into Canada is not readily countered so as to give Canadian firms of equal efficiency an equal chance of success. A vigorous enforcement of a domestic competition policy can help to remove some of the artificial barriers (i.e., those not based on any different qualities of product) to the entry of more efficient operators and to contribute to the reduction of some of the disadvantages of product differentiation which is supported or expanded by these techniques—both by foreign owned and Canadian owned firms.

The remedy of reducing tariff and other trade barriers can become increasingly less effective in overcoming inadequacies of competition in Canada if most potential suppliers of comparable strength in terms of market image are already located in Canada through direct investment, particularly in the case of industries that are oligopolistic internationally—that is, industries dominated by relatively few firms of large size. Nevertheless, even in these industries there remains some scope for increasing efficiency if a reduction in trade barriers leads to a degree of international rationalization of production between the parent organization and the Canadian subsidiary.

While this analysis has primarily considered the potentially adverse effects of foreign investment on competition, the competitive advantages of the foreign owned firms can also work to Canada's benefit. In some industries, Canadian firms are likely to find entry difficult. In fact, entry without the advantages of having a foreign parent may be virtually impossible in some industries. These advantages include the capacity to enter in a truncated form—capitalizing on the economies of scale which come from the centralized performance of many of the functions of the parental head office or from elsewhere in the corporate structure. Under these circumstances, new

foreign investment can stimulate domestic competition, induce innovation and cost saving by all the Canadian firms, and thus benefit the Canadian economy.

NATURAL RESOURCES

The above discussion has focused on the manufacturing sector of the economy. Following is a similar analysis of the resource industries.

Foreign raw material processing and fabricating firms tend to integrate backwards in order to control their own inputs. This makes the operation of a mine in Canada by an independent firm more difficult in some cases because markets are foreclosed by virtue of vertical integration. Similarly, if economically attractive resources are owned by foreign processing firms which need the inputs for their own operations, independent operations of processing facilities are also made more difficult.

Canadian natural resource development is characterized frequently by significant degrees of vertical integration—as is the case in most economies of the world. The high degree of foreign ownership in this sector has been noted earlier in this study. The primary motivation for this integration and foreign control is the desire of foreign firms to maintain their strength in their home markets—rather than to increase their domination of the Canadian market. It has, nevertheless, resulted in barriers to entry and concentration in some of the Canadian resource industries.

The average firm in the mineral industry is half as large again as the average manufacturing firm (assets of $3.2 million versus $1.9 million). It is also more capital intensive that its manufacturing counterpart. In 1967, $1 in sales required assets of $2.97 in the mineral industry and 90 cents in the total manufacturing industry.

The average size of mining industry firms controlled by non-residents is over five times larger by all standards of measurement than that of firms controlled by Canadians. Average assets for foreign controlled firms were $17 million in 1967 versus $3.8 million for Canadian controlled firms. Whereas foreign controlled firms represent 11.5 per cent of total firms, they own sixty per cent of industry assets. In addition, the assets per foreign controlled firm in the mining industry are about four times greater than the assets of Canadian controlled counterparts.

The big foreign controlled firms are particularly concentrated in petroleum and coal products (24 firms with average assets of $198 million), smelting and refining (28 firms with average assets of $86 million), primary metals (60 firms with average assets of $52 million), and metal mining (63 firms with average assets of $31 million). The eight largest firms in petroleum accounted for over eighty per cent of industry sales in 1968. The four largest firms in primary smelting and refining accounted for nearly ninety per cent of production.

Of the 46 mineral industries surveyed, a study shows that 32 are *very* highly concentrated; 5 are *of high* concentration; and 4 are *fairly* highly concentrated. Only 3 were regarded as fairly low and 2 as low.[30] Mining is more highly concentrated than manufacturing. Fuel production (e.g., oil wells) was of very low concentration. Mineral based manufacturing (primary metals, petroleum and coal products, and non-metallic mineral products) is relatively highly concentrated.

Barriers to entry are significant and world-wide integration of firms is not infrequent in this sector. While product differentiation is not relevant at the primary stages, capital requirements and foreclosed markets are significant impediments to independent Canadian entry.

CONCLUSIONS

Foreign direct investment can reduce competition in Canada—and may do so without adding benefits to the Canadian economy. If the competitive advantage of the foreign firm is not based on technological superiority or efficiency, or if the efficiencies are not transmitted to the Canadian market-place, Canada generally does not benefit. In some cases of a new investment by a foreign firm for the manufacture of a product based on its own market differentiation, the addition of an alternative source of production can help to promote greater competition in the industry. In such cases, the increased competition may produce pressures for greater efficiency and the transmission of such benefits to the market-place. This is more likely to be the case if a new investment brings an additional differentiated product to the market than if there is a foreign takeover of a Canadian firm already marketing its own product.

The statistics cited in this chapter indicate the large size of foreign owned firms, their dominant position in many Canadian industries, and the fact that the industries which they dominate tend to be concentrated and often characterized by product differentiation. Foreign investment may simply introduce concentration or artificial product differentiation into Canada with little or no offsetting benefit. Furthermore, foreign investment may extend the world-wide pattern of concentration and product differentiation into Canada. Competition in Canada might thus be reduced, and independent entry of Canadian owned firms made considerably more difficult.

Domestic policy on competition can resolve some of the concerns raised here. Since mergers are part of the concern of the proposed *Competition*

[30] Stewart, *op. cit.*

The basis of the categorizing was to add the total number of firms whose output had to be included to account for 80 per cent of the production of the industry:

up to 4 firms—Very high
4 to 8 firms—High
8 to 20 firms—Fairly high
20 to 60 firms—Fairly low
over 60 firms—Low.

Act, foreign takeovers having adverse competitive implications, with little or no offsetting justification based on efficiencies, could be prohibited. Bill C-256 stipulated that prohibition ought to be considered in the case of takeovers which: significantly reduce domestic competition; reduce export opportunities for Canadian firms; extend market dominance from abroad into Canada or otherwise increase or maintain market concentration; integrate a Canadian firm into an international cartel or curtail the vigour of Canadian competition by placing the Canadian firm into an international pattern of concentration. In each case, if the acquisition were to increase efficiency to the benefit of the Canadian market, the acquisition would not offend the proposed *Competition Act.* The purchasing of a viable Canadian firm by a foreign firm, without adding any capacities which will make the firm more efficient, is of no advantage to Canada. If such a merger has any of the adverse effects set out above, it is harmful to Canadian interests from the point of view of competition and efficiency.

Aside from the role for legislation in connection with mergers, the competitive impact of new foreign investment is a further aspect of the potential benefit or cost to the Canadian economy from foreign investment. Just as a foreign takeover might make a previously ineffective firm more competitive and innovative, new foreign investment could add considerably to the domestic competitive environment. In fact, it is possible that in some industries only foreign investment can be expected to add new suppliers to the domestic market in view of the barriers to entry which only an established firm can overcome. The foreign firm might be able to surmount more easily the obstacle of high capital requirements through internally available funds, superior credit-worthiness in Canada, or easier access to foreign capital markets. It might possess some distinctive advantage (perhaps a degree of product differentiation of its own to rival present producers), it might be able to achieve the economies of scale of some functions which only international markets for the spreading of certain costs can support. Truncated entry is possible for such a firm, expanding the scope of its Canadian activities as its market expands. The new entrant might also be less likely to be guided by the local "business norms" which constrain competition.

In addition to stimulating competition in his own industry, the foreign entrant (in attempting to improve his own margin of profit) might also stimulate improved performance from suppliers—possibly by instructing suppliers and related industries in improved techniques.

As noted in the earlier part of this chapter, however, foreign investment historically has not always added to the competitive vigour of the Cannadian market. Foreign takeovers are more likely than new investment to reduce competition—and the acquisition by a foreigner of a dominant Canadian firm is more likely than a foreign acquisition of a smaller firm to restrict competition. The competitive impact of a new foreign investment which adds no new technology or efficiencies to Canada can be equally adverse. Such entry can constitute a technique for extending domination in the Canadian market

and achieving the restrictions observed in the case of takeovers. Consequently, any review procedure would have to bear in mind these aspects of foreign investment.

A further complication which foreign control poses for Canadian competition policy is that of agreements entered into by the parent or affiliated firms abroad which affect the behaviour of the Canadian subsidiary, such as a directive from the parent to the Canadian firm allocating markets as part of an international cartel arrangement. Even where several subsidiaries are thus made to act out the terms of an agreement, present Canadian law cannot get at the root of the problem since the parties in Canada have not actually participated in the agreement as a matter of law. If the parent company itself operated in Canada, it could be charged. The mere fact that an incorporated subsidiary, rather than the parent itself, is doing business in Canada permits Canadian law on conspiracies to be circumvented. This has been a problem in some cases in the past. It is likely to become increasingly important with the growth of MNE's.

Chapter Thirteen

TRANSFER PRICING AND TAX ADMINISTRATION

INTRODUCTION

Taxation policy, both domestic and foreign, frequently has an important influence on the allocation of funds and resources within an economy. Tax policy can have an important bearing on the differential in opportunities for Canadian and foreign controlled enterprises operating in this country. By the same token, there are several aspects of tax policy which have a bearing on the filling of "gaps" in the capacities of the Canadian economy. A number of these considerations have been taken into account in the recent reform of the income tax legislation. However, there are limits to the impact these new tax measures can be expected to have on the forces that bring about foreign investment in Canada.

This chapter deals with the narrower issue of some of the techniques used by Canadian firms which have international affiliations—whether foreign or Canadian controlled—to reduce their tax burden in Canada. These techniques can adversely affect the national interest by reducing tax revenues from foreign controlled operations in Canada.

If a foreign controlled corporation or MNE can avoid paying taxes in Canada, the firm is put at a considerable advantage over its Canadian competitors—unless it must pay an equal amount of tax outside Canada on the profits earned from Canadian sales.

This is part of a broader policy issue involving the business profits in the hands of both Canadian companies with foreign operations and foreign companies with Canadian operations which the Canadian government should seek to tax.

A Canadian parent firm can earn sales, service or investment income within Canada or from dealings entirely outside of Canada. On income from domestic operations, Canada imposes a corporate tax. It does not matter whether the firm is selling to Canadian buyers or to foreign buyers, the tax applies equally. If the foreign buyer is an affiliate of the Canadian firm, the prices set on goods and services "sold" are subject to adjustment on reassessment by the tax authorities if the sale is at other than at fair market value. This is to avoid an unreasonably low price being set for the

purpose of artificially shifting profits to the foreign based affiliate, where taxes might be lower than in Canada. Conversely, imports from such an affiliate might be priced unreasonably high and require reassessment for the same reason. These transactions bear particularly close watching when one of the affiliates is based in a "tax haven".

The income of foreign subsidiaries of Canadian firms might come from sales and service activities carried on entirely outside Canada. To tax such income (particularly if it were taxed prior to its repatriation to the Canadian parent) might place Canadian companies at a competitive disadvantage vis-à-vis foreign competitors who are able to take advantage of any lower taxes accorded certain classes of income in some other countries. However, not to tax income from foreign sources may well serve as an inappropriate incentive to Canadian investment in foreign, as opposed to domestic, activities. Clearly a compromise between conflicting objectives is necessary if the system of taxing foreign source income is to protect the competitive position of Canadian-based companies and at the same time avoid granting a type of tax subsidy to foreign investment.

The Canadian subsidiary of a foreign firm is clearly taxable in Canada—and Section 69 of the *Income Tax Act* does require that transactions with non-arm's length firms be at fair market values. This does not, of course, mean that Canada is drawing as much tax revenue as it might in all circumstances. Canada might, for example, derive increased benefit, in terms of revenue and employment, if further processing were done in Canada before export. The capturing of these "downstream profits" by one means or another involves important policy issues—particularly where the tax on income derived from the extraction of raw materials has been set at a low level to encourage such activity in Canada.

The aspect dealt with in this chapter is that of international transactions involving Canada. Where a disproportionately low amout of income is earned in Canada by a domestic subsidiary, the reason may lie in the artificial diversion of profits from Canada. In these circumstances, it is within Canada's ability to capture some greater part of the global earnings of the enterprise.

A consideration of transactions moving through Canada involves Canadian and foreign owned firms alike, although foreign owned firms probably account for a greater volume of non-arm's length transactions than Canadian owned firms. For these purposes, Section 69 provides a legal basis for dealing with the problem to the extent it exists. There would seem to be no reason why a Canadian firm selling to a Canadian buyer should pay more taxes than a firm selling to a foreign market through the vehicle of a foreign affiliate. If the degree of taxation would place the Canadian sourced goods and services at a competitive disadvantage in international markets, a more general policy judgment on tax levels and international competitiveness is necessary.

Of primary concern here is the use of transfer prices set by agreement between related companies, since the extent of import and export activity

that revolves around foreign controlled firms makes this consideration particularly important. The payments for services which flow between affiliated companies can have a similar impact.

A firm evaluates the profitability of an investment in Canada on the basis of its net effect on the company's total business operations. This includes not only profits earned by the Canadian affiliates, but also earnings which the parent derives from the subsidiary in the form of royalties, management fees, and profits on the inter-affiliate sale of components and capital goods. Similarly, interest on funds provided to the subsidiary may add to the profitability of the Canadian investment. These various avenues for returning profits to a foreign investor also permit a certain flexibility and ability to minimize the total tax burden of the Canadian company. It is necessary for any country exposed to numerous international transactions which are not at arm's length to police the values set on these transfers to avoid a potentially serious loss of tax revenues.

TRANSFER PRICING

In the absence of any controls on actual capital flows, the reassessment of transfer prices on goods or services between affiliated companies affects only the tax revenues of the host and home governments. The companies involved remain free to move funds as they see fit, subject only to this constraint of paying the appropriate taxes.

The taxable profits of a Canadian firm can be made to vary dramatically by means of ostensibly minor changes in transfer prices. The tax revenues resulting from a foreign investment can be an important part of the benefits received by the host jurisdiction. These revenues are drawn out by the host government before the home government taxes the proceeds on repatriation. So long as the tax levels in the host jurisdiction are not above those of the home jurisdiction, and provided the home government permits the taxpayer to take credit for taxes paid to a foreign government, the taxpayer does not lose anything by the payment of taxes in the host economy. The MNE can frequently offset higher Canadian taxes through the tax credit granted by the home country on other foreign income that is taxed abroad at levels which are below those at home.

The potential impact on taxable income of a relatively minor change in the transfer price can be illustrated by a simple example:

	A	B
Transfer price into Canada	$10.00	$10.50
Selling price in Canada	12.00	12.00
Gross profits in Canada	2.00	1.50
Local expenses in Canada	1.00	1.00
Net profit per unit..............	$ 1.00	$ .50

An increase of five per cent in the transfer price charged to the subsidiary reduces by fifty per cent the taxable income in Canada.

While a firm could seek to move profits out of Canada by increasing the charges imposed on the subsidiary (or decreasing the price paid for purchases from the subsidiary), the reverse might also occur. That is, the Canadian subsidiary might be undercharged for purchases from the parent or overpaid for sales to the parent. The prevailing corporate tax levels in Canada and the increased vigilance of United States tax authorities over transfer pricing since the early 1960's make this area one of legitimate interest for Canadian authorities.

There do exist motives other than tax liability for the shifting of taxable income by means of adjustments to inter-affiliate transfer pricing. The existence of minority shareholdings in Canada might induce a controlling shareholder to minimize the earnings of a partially owned affiliate.

The *Income Tax Act* deals with the matter of transfer pricing (in Section 69) by requiring that prices in non-arm's length transactions be set at a "fair market value" or at a "reasonable amount" for goods and services. Where an open market price exists for the item involved, the "fair market value" is reasonably easy to set. When dealing with components for which there is no open market, or with charges by the parent to a subsidiary for costs of management, research, sales and technical assistance, royalties and interest on funds, the task is considerably more complicated. The setting of prices for such transfers can be quite difficult and arbitrary. Evidence of this is seen from the fact that the two divisions of the Department of National Revenue, Taxation and Customs and Excise—each operating under different statutes—have been known to set different "fair market values" on the same commodities.[31] Customs officials have a tendency to seek as high a level as is reasonable on imports, while taxation officials can be expected to lean to the lowest reasonable value.

Customs law and procedures generally are biased toward high import prices, reflecting their concern with safeguarding the level of protection Parliament affords to Canadian producers to encourage Canadian production, employment and development generally—regardless of ownership considerations. At the same time, this policy can have an adverse effect on the benefits accruing to Canada from the operation of foreign owned subsidiaries in terms of reducing the taxable base of these firms, facilitating transfers of profits to other jurisdictions and increasing the level of Canadian production costs via higher import prices.

The issue of transfer pricing with regard to service payments, royalties on technology, and administrative and management services ordinarily provided by the head office is also very important. To what extent, for example, should the salary of president of the parent be charged to the earnings of foreign subsidiaries. Such assignments of costs are even more difficult to

[31] The criterion of "fair market value" for duty purposes is laid down in Section 36(1) of the *Customs Act*.

assess than the fair market value on commodities. Some host countries treat salaries of officers of the parent corporation as expenses of that corporation and insist that the total cost be ascribed to the parent—not as an expense to be borne by the subsidiary for purposes of earning income. To make a proper assessment of the various charges, the taxation authorities require fairly detailed information on both the Canadian firm and the foreign affiliate.

The present legislation empowers the Department of National Revenue to review all such charges and to reassess the taxpayer at the level of the "fair market value". In the administration of the *Income Tax Act,* the individual tax auditor is given considerable discretion in determining whether particular non-arm's length transfer prices or other intra-company payments should be questioned. Periodic auditing tests are made in cases where intra-company transactions occur. The procedure for determining fair market value is to ascertain the price to strangers in similar circumstances. Where such a value cannot be readily ascertained, it can prove difficult to gather adequate evidence to challenge the taxpayer.

The enforcement of these tax provisions falls into the general pattern of tax administration—a periodic auditing of tax-paying corporations, plus the closer examination of questionable cases. It is not clear whether a more intensive enforcement of the transfer price provisions would produce significant new revenues or lead to wider compliance, since the evidence on the extent of non-compliance is rather limited.

The legislation provides for reassessment authority in cases of "non-arm's length" transactions. The tax returns of international companies do not identify which transactions fall into this category, so that some difficulty is experienced in identifying the transactions to which to apply the relevant section of the Act. Furthermore, there are no regulations stipulating the manner in which "fair market value" is to be set in such circumstances. The *Customs Act* does provide for a regulation-making power to govern the determination of fair market value for its purposes. Consideration might usefully be given to providing similar authority under the *Income Tax Act,* although the problem of establishing the substance of the rules remains.

Transfer pricing has been discussed here solely as a consideration involving tax revenue. It is worth noting, however, that the prices set on transactions between affiliated firms may also perform other functions if the corporate management chooses to use prices and profits as a technique of management control. The transfer price charged affects the profitability of the subsidiary. If the subsidiary is directed by a defined profit target, the transfer price can be used to influence the subsidiary to ensure that its decisions accord with the global strategy of the firm. The subsidiary management will act so as to maximize its own profits, but it will do so within an environment which is shaped by the "control system", of which the transfer pricing forms a part. This aspect is not developed in this study, since the control system can readily be changed by the parent and is employed in lieu of more

direct managerial control by the parent. That is, it permits apparent decentralization of decision-making—without the loss of "real" control. The decisions of the subsidiary are then maintained as compatible with the global interests of the firm. In this respect, the investment or other resource allocation decisions are ultimately determined by the parent and are not influenced by the transfer price techniques for moving profits around the corporate system. The determinants of the investments and their location are based on the more fundamental economic and business considerations.

For example, under some circumstances inter-affiliate transactions may be undertaken at incremental cost—so as to avoid idle capacity in one place while the firm in another place either builds new capacity or purchases from an outside source. Under other conditions, the transaction might be priced at market prices—so as to keep the supplying operation efficient by market standards. The price set for "control" purposes can be different from that used for tax return purposes and has clearly different objectives. This chapter does not deal with this aspect and has examined transfer pricing from the single perspective of the shifting of profits around the corporate system.

OTHER TECHNIQUES FOR REDUCING TAX REVENUES

Techniques to minimize taxes are engaged in by all corporations regardless of whether they are Canadian or foreign controlled. There are very few that have special significance for foreign controlled firms that have not been dealt with under the former or amended tax law. Brief mention should be made, however, of one other technique.

"Thin capitalization"—the practice under which an investor places an excessive portion of his investment capital in the form of debt, rather than equity—permits the deduction from taxable income of interest charges and the distribution of business profits in the guise of a return of loan capital. When the transaction spreads over a national border, Canadian tax revenues are more seriously affected.

While thin capitalization can impair the ability of the corporation involved to raise further debt from outsiders, the foreign controlled subsidiary may find its credit-worthiness to rest ultimately with the parent firm. As a result, there would be fewer constraints on thin capitalization.

Recognizing this problem, the new *Income Tax Act* provides for the denial of tax deductibility of excess interest to shareholders (i.e., where the debt to equity ratio exceeds three to one) and for the treatment of such excess transfers as dividend payments.

A similar but opposite technique is followed by some Canadian companies. In this case, the Canadian company is inclined to invest in shares of a foreign affiliate, rather than in debt, in order to realize its return in the form of tax-free dividends, rather than taxable interest income from a foreign

affiliate. This is particularly attractive if the Canadian company can arrange to deduct the interest paid on funds borrowed to invest in the shares of the foreign subsidiary.

CONCLUSIONS

It is reasonable for international enterprises to arrange their affairs to minimize their tax burden on the total corporate venture. It is equally legitimate for host governments to seek for themselves a fair share of tax revenues based on the income derived from business activity.

The issue of what income should be subject to tax is beyond the scope of this study. The concern here is simply to assure that domestic laws are effective in securing the revenues which it is Canadian policy to collect.

The principal concern in this regard relates to the prices on goods and services and other charges between affiliated firms, which make it possible for taxable income to be shifted out of Canada. The law on this point is probably sufficient. The extent of inter-affiliate dealings warrants paying particular attention to the way in which the law is administered.

Chapter Fourteen

BALANCE OF PAYMENTS IMPACT OF FOREIGN DIRECT INVESTMENT

Earlier in the study,[32] one question considered was whether it was important to have continuing inflows of direct investment from abroad for balance of payments reasons in light of the present and prospective state of that balance over the next few years.

This chapter is concerned with a related but separate issue, namely, the balance of payments consequences of foreign direct investment. The analysis here is not as much concerned with the immediate impact of direct investment for the balance of payments as with ways in which the balance of payments is affected over a period of time by foreign direct investment. Unlike the earlier analysis, it is more concerned with the impact of a particular investment of the balance of payments and less with the aggregate effect of all direct flows in any given time period.

Economic research thus far does not permit any precise links to be drawn between foreign direct investment and other elements in the balance of payments. However, the kinds of outflows and inflows on the balance of payments resulting from foreign direct investment can be identified.

A foreign direct investment in Canada gives rise to continuing payments abroad. Of these outflows, the most evident and important is the remittance of dividends. (Profits which are retained within the Canadian enterprise are, in effect, further direct investment. They are recorded by some countries as both outflows and offsetting capital inflows, but their real effect is not upon the year-to-year payments position so much as on a country's balance of long-term indebtedness.) Interest payments on funded debt between affiliates are small. The "other business service payments" on the non-merchandise or invisible account relate to royalties, management fees, engineering and advertising fees, insurance and so on. Data covering two recent years for these items are shown in Table 46 below, which includes payments to foreign parents and affiliates only.

These totals, incidentally, are very roughly equal to one half of total Canadian payments to non-residents for dividends, interest and other

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[32] See Chapter Six.

TABLE 46

PAYMENTS BY FOREIGN CONTROLLED FIRMS
TO NON-RESIDENT PARENTS AND AFFILIATES*

	1967	1968
	$ Million	
Dividends	516	490
Interest on Funded Debt	10	11
Other Business Service Payments	395	463
Totals	921	964

*SOURCE: Statistics Canada.

business services. The difference is made up by several factors: payments abroad by foreign controlled firms to non-affiliates (which includes all of the payments by foreign controlled firms that have no foreign parent, such as the International Nickel Company of Canada), interest payments on borrowings by foreign controlled firms by way of bank loans; and all payments by Canadian controlled firms and governments (e.g., provincial borrowings) to non-residents.

In addition to these large payments on the invisibles account, there is a big and ever-growing volume of payments on the merchandise account, due to the tendency of foreign controlled firms to buy an increasing proportion of their needs abroad. As explained above,[33] foreign controlled firms are more import-oriented than Canadian controlled firms. About thirty per cent of Canada's import trade is from affiliates, worth around $4 billion. A proportion of this might not flow out of Canada in the event that these firms were Canadian controlled, since Canadian controlled firms are less import-oriented.[34]

In addition to the continuing payments referred to above, direct investment may be accompanied by imports of machinery, equipment, other merchandise and business and professional services associated with the initial investment. For instance, in establishing a new chemical plant in Canada, a foreigner may bring with him from his home country specialized machinery and equipment.

There are also less direct and less immediate effects on the balance of payments. To the extent foreign direct investment leads to expenditures on Canadian property, goods, manpower and services (rather than on imported goods, manpower and services), these expenditures result in increased Canadian investment and consumption. This has a wealth-creating effect in Canada, which may lead indirectly to higher imports of goods and services.

[33] See Chapter Eleven.

[34] This, of course, does not mean that it would be more economically efficient for all these firms to be Canadian controlled.

On the credit side, the initial direct investment often brings with it foreign exchange,[35] although this is not the case in the event of a share swap or if the investment is made wholly through borrowings in Canada.

In addition, when productive capacity is increased by foreign direct investment, there is the likelihood of either a direct or indirect increase in exports or displacement of imports. But before concluding that this constitutes a surplus-creating impact on the balance of payments, it is necessary to know what would happen if the direct investment were not made. For instance, it is possible that the foreigner is exporting to Canada in small volumes (causing a deficit impact on the Canadian balance of payments) and that he has built a sufficient export volume in Canada to justify building a plant here. In the case of secondary industry, it would be important to know whether the foreigner could expect to maintain and to expand his Canadian market if he did not invest here. In the case of resource exploitation, it would also be important to know if and when a Canadian developer would likely come along in the event that the foreign investment were held back, and if the Canadian developer would tend to behave differently, for instance, by exporting more or undertaking more processing. While a foreign direct investment is likely either to reduce imports or increase exports, it is conceivable that in the absence of the foreign investment this would happen through a domestic investment. Where it would not happen by domestic investment, this aspect of foreign investment has a surplus-creating effect.

The maturity of the investment is also important in assessing its balance of payments impact. To the extent that an investment has become fully operational, the capacity of the foreign owner to draw off large profits is enhanced. However, this does not necessarily mean that the Canadian payments position is progressively weakened as an investment matures, since the export potential or import replacement potential of the investment would similarly be reached only when the investment is fully operational. Many of the other factors referred to above are similarly affected by the maturity of the investment.

As the balance of payments is essentially an aggregate phenomenon, close examination of each direct investment would not only be time consuming and very difficult, it would also be of limited usefulness as particular transactions constitute only a very small part of the entire payments flow and thus individual investments can influence the structure of the balance of payments only very slightly. However, experience could demonstrate that the overall balance of payments impact of direct foreign investment in one industry is generally different than in another industry. This is a matter for analysis through time as techniques are developed for making the necessary studies and the required data are gathered. Should this reveal that the overall balance of payments impact of direct foreign investment in one industry is generally different than for any other, that might constitute reason for a general bias—if the balance of payments were of particular concern to us—

[35] The fact that this may have an adverse balance of payments impact in some circumstances has been dealt with previously.

but not an absolute rule for or against direct investment in particular sectors. As a general rule, this analysis suggests that Canada should concentrate on the "real" effects of foreign direct investment in terms of production, employment and incomes. If Canada possesses the industrial structure and degree of efficiency necessary to produce the levels of economic activity and employment that are desired by the nation (including the access to export markets that may be necessary to achieve the economies of scale), then the balance of payments effects of foreign direct investment should not be a matter of concern. If there is an overall balance of payments problem that it is believed needs to be corrected, then it should by preference be dealt with through the use of more general economic tools, rather than through measures that concern themselves with the impact on the balance of payments of a particular industry.

While no quantitative studies have been carried out in Canada, studies have been done in the United States and United Kingdom on the balance of payments consequences of foreign direct investment. The United States study, carried out for the United States Treasury as a result of its concerns about United States balance of payments problems, is of greatest relevance for Canada.[36]

The study for the United States Treasury is filled with sufficient qualifications that the quantities involved can at best be taken only as rough indicators of orders of magnitude. It nonetheless does represent the best information available on this subject. According to the study, the balance of payments impact of any single investment can vary very widely. Using the assumptions in the study which seem most relevant for Canada, it would appear that, on average, it takes the United States ten years to recoup through all flows on the balance of payments an amount equal to its original capital investment in Canada. In some particular cases, the United States never recoups its initial investment in Canada, suggesting that some investments, even in the long run, have a surplus-creating effect on the Canadian balance of payments. But on average, it would appear that United States direct investment in Canada has deficit impact on the Canadian balance of payments after a period of around ten years.

The other factor which is of particular interest is the kind of limitations which foreign controlled Canadian firms often have imposed upon them by their parents, as these also have a balance of payments impact. Restrictions upon export opportunities of a Canadian subsidiary or requirements to purchase goods and services from a foreign parent or from the foreign parent's supplier can have a deficit-creating impact on the Canadian balance of payments. In practice, such restrictions have this impact only if they prevent export sales or domestic purchases that would take place in the absence of directives from the parent. As available data suggest that more and more of Canada's international trade is between affiliated firms, the potential signif-

[36] G. C. Hufbauer and F. M. Adler, *Overseas Manufacturing Investment and the Balance of Payments,* U.S. Treasury Department, Washington, D.C.

icance of such restrictions is not unimportant. For the same reason, manipulation of transfer prices in trade in goods and services between subsidiary and parent, if sufficiently widespread, can have a significant impact on the balance of payments.

In some quarters recently, concern has been expressed over the fact that the annual outflows on the current account for servicing foreign investment (i.e., the interest and dividends) exceed the annual inflows of the investment in long-term form. For example, in the twelve months ended September 1970, payments of interest and dividends on all foreign investment (direct and portfolio) were a little more than \$1.5 billion. The net outflow for servicing foreign investment (i.e., payments minus receipts) was around \$1 billion.

Against this, imports of direct investment (imports minus exports of direct investment) were \$476 million. Thus, it is claimed Canada is now exporting more capital than it imports. Other persons, using different figures, have made similar types of comparisons.

This kind of argument is based on conceptually untenable premises. It has been noted above that, for balance of payments reasons, Canada has no particular need for foreign direct investment. The reasons put forward earlier, however, related to the strength of the current account. The arguments set out here compare the volume of new investment against the cost of servicing all previously accumulated investment. To compare annual interest and dividend payments to the flow of new investment is no more relevant than to compare the cost of servicing previously accumulated personal debts in any one year (mortgage payments, personal loans, etc.) to the volume of new debts one can accumulate.

If one is concerned about whether Canada is paying too much for foreign capital, then it is necessary to measure the cost of the foreign direct investment to Canada against its worth. This would require adding up interest, dividends and any other payments to the parent which could not be directly attributed to a good or service being provided by the parent and then comparing this annual payment to the value of the parent's accumulated investment in Canada—in effect, measuring the cost of capital.

In summary, it is evident that to determine fully the long-term impact of a foreign direct investment on the Canadian balance of payments requires tracing through a series of direct and indirect consequences. Some efforts have been made to do this, but thus far this research does not permit precise quantification of the relationships. The best study available suggests that United States direct investments in Canada, on the average, have an aggregate deficit impact on the Canadian balance of payments after a period in excess of ten years.

If it were demonstrated that the balance of payments consequences of direct investment in Canada over a period of time were substantially more adverse in some sectors of the economy than in others, this might be reason to have some degree of bias against additional direct investment in that sector if the factors responsible for such adverse consequences could not be overcome.

Chapter Fifteen

THE IMPACT OF FOREIGN OWNERSHIP AND CONTROL OF CANADIAN BUSINESS ON CANADIAN MONETARY POLICY

It is frequently asserted by some authorities that the high degree of foreign ownership and control of Canadian business reduces the effectiveness of Canadian monetary policy. The argument goes something as follows: during periods of monetary restraint, the foreign controlled company can thwart Canadian economic objectives by drawing on cash reserves or credit of its foreign parent; during periods of monetary expansion, the foreign controlled company may be required to respond to demands of its parent, which may draw funds out of Canada because of other priorities. In either case the foreign controlled firm circumvents the objectives of Canadian economic policy in general and monetary policy in particular. This chapter examines the validity of such assertions.

MONETARY POLICY AND THE BALANCE OF PAYMENTS MECHANISM

In broad terms the objective of monetary policy is to control credit conditions in the light of the current and prospective state of the economy. The flow of funds into and out of Canada (including direct investment) can, in certain circumstances, make the achievement of this objective more difficult through its impact on the structure of the balance of payments. In this respect, capital flows are not unlike trade flows, which can also have repercussions on monetary policy through the balance of payments.

If a capital inflow is offset by a corresponding outflow of capital or payment for imports of goods or services, there is no impact on the balance of payments—nor pressure on reserves, the exchange rate, or price levels—and hence it is less likely to raise complications for monetary policy. If a capital outflow is offset by a corresponding inflow, the same considerations apply.

On the other hand, if capital inflows are not offset by corresponding outflows, they can necessitate a shift in monetary policy. For example, assume

a tight money situation in Canada relative to the United States and also, for the sake of simplicity, a fixed exchange rate. In these circumstances, capital tends to flow into Canada. To maintain the exchange rate, it must be taken into reserves, which, in turn, must be acquired through the use of government cash. Over a period of time this could lead to a drain on government cash balances. If these are run too low, the government must raise additional cash either through taxes or by selling securities.[37]

The problem for the monetary authorities arises principally because they cannot fix both interest rates and the money supply at the same time. If the government seeks to sell securities, without any parallel increase in the money supply by the monetary authorities, it would probably have to raise its interest rates, which in turn would tend to push up interest levels generally, which because of the "openness" of Canadian capital markets would induce further capital inflows, either by forcing Canadian borrowers to find funds abroad or attracting the funds of foreigners seeking higher returns in Canada. Therefore, action by the government to raise the necessary funds to finance the external imbalance merely exacerbates the problem. On the other hand, if the monetary authorities seek to maintain interest rate levels in order to reduce the prospect of further capital inflows, they would have to be prepared to hold additional securities themselves and thereby increase the money supply. This expansion of the money supply would, of course, be inconsistent with the desired policy of credit restraint.

It should be borne in mind that a capital inflow can itself affect the balance of payments adjustment process. This can occur in at least three ways:

(i) A capital inflow (especially in the form of direct investment) may involve the immediate importation of goods or services (e.g., machinery or feasibility studies).

(ii) The wealth-creating effects of an inflow can encourage increased consumption and consequently increased imports.

(iii) If the monetary authorities have a view about the appropriate exchange rate for Canada and move to protect it by adding to reserves, this could lead to an increase in the money supply. The resultant fall in domestic interest rates could lead to capital outflows as funds sought higher returns elsewhere, which would exert downward pressure on the exchange rate.

Similar considerations apply to a capital outflow.

The degree of impact of a capital flow on monetary policy depends in part on exchange rate policy. If exchange rates are free to find their own levels, the task for the monetary authorities is somewhat eased, since the exchange rate will absorb at least part of the impact which, under conditions

[37] The fiscal option is seldom used because of the time lag problem and the difficulties in raising taxes, but it is relevant to note that in theory, at least, the openness of the Canadian economy and concomitant capital flows can affect the ability of the government to have an "independent" fiscal policy.

of fixed rates of exchange, would fall entirely on the level of reserves. To the extent that movement of the exchange rate reduces pressures on the reserves, the monetary authorities are freer to conduct monetary policy in the light of credit conditions in the economy. This would probably lead to a more stable monetary policy than is possible under a fixed exchange rate.

The use of a floating exchange rate would not change the direction of adjustment required to bring the balance of payments into equilibrium—some change in Canadian price levels relative to international price levels would be required whether the exchange rate were fixed or floating. It is possible that the relative distribution of the burden of adjustment, in terms of sectors of the economy or classes of the population, under fixed or floating rates would be different, but, given the present state of knowledge, this cannot be effectively measured.

Canadian government policy over the years has been to permit the free flow of all forms of capital between Canada and other countries. Indeed, one of the anomalies of the Canadian financial system is that there are fewer imperfections between Canadian and international (i.e., New York) capital markets than there are within the national market. This international "openness", resulting from financial intermediaries, large multinational enterprises and even some smaller Canadian companies acting as conduits for funds—borrowing where interest rates are low and lending where capital is scarce—has left little room for a significant divergence between Canadian and foreign monetary policies and the traditional spreads between Canadian and foreign interest rates. Because of this "openness" and the magnitude and variability of capital flows, especially in short-term form, the Canadian market is likely to feel the impact of changes in monetary conditions both at home and abroad. It is also subject to changes induced by foreign government policies, such as the United States interest equalization tax and balance of payments programme.

Of course, there are ways of insulating the Canadian economy, at least to some degree, from the effects of changes in foreign monetary conditions so as to allow greater domestic control of monetary policy. Mention has already been made of the implications of a floating exchange rate, for monetary policy, but it should be noted that a floating rate creates uncertainty for Canadians involved in international trade. The introduction of foreign exchange controls would be another instrument for lessening the impact of changes in external monetary conditions. This technique could involve significant distortions in the process governing the international allocation of capital, but it should be borne in mind that a number of distortions have already been introduced in this process, for example by the United States balance of payments programme, the preference of the capital market for large fims, and the barriers to entry to the financial industry. However, direct controls on foreign exchange transactions are likely to be less palatable—politically or socially—unless they are urgently required to serve the national

interest. They would also be difficult to administer in an economy as open as Canada's if they covered inflows and outflows of funds for a wide range of purposes.

A foreign inflow puts the Canadian borrower (or foreign investor) in a position to make an immediate claim on real Canadian resources and may thus effect a shift from one potential set of users of these real resources to another. If the foreign investor happens to be a foreign multinational firm, and assuming there is no increase in the money supply, it is possible he is displacing a Canadian user of that real resource. Whether an increase in the money supply has an inflationary impact would largely depend upon the extent to which the particular capital inflow generates an increase in real production equivalent to the increase in the money supply. If there is an inflationary increase in the money supply, the inflationary impact is borne by the whole economy and only partly by this priority claimant on real resources.

FOREIGN CONTROL AND MONETARY POLICY

It is against this background that we should consider whether the number and size of foreign controlled business concerns operating in Canada lead to a proportionately greater level of inflows and outflows and changes in their pattern and timing than otherwise would be the case, thus increasing the exposure of the Canadian monetary system.

During periods of credit restraint in Canada, some foreign controlled subsidiaries have pursued expansionary investment programmes. While this also occurs in the case of Canadian owned firms, foreign controlled firms probably have easier access to capital because they are able to draw on the relatively large resources of parent and affiliated companies for cash requirements (depending, of course, on the availability of funds and the parent company's other priorities). The foreign controlled company's familiarity with foreign money markets (through its parent's contacts or its own international dealings) makes borrowing abroad easier and perhaps less costly, especially if the parent's name is used or a parental guarantee is obtained. Although there is some evidence that interest rates in Canada and the United States for comparable debt may not be very different, in general, lower interest rates in the United States have in the past favoured the parent consolidating the debt of all subsidiaries and raising the money in the United States. Recent United States preoccupation with its balance of payments appears to have reduced this tendency. It should be noted that the multinational structures make it extremely easy to move capital between affiliated companies either through loans, transfer pricing, variations in the payments of accounts payable and receivable or other similar conduits. While this flexibility may enable an MNE to react more quickly than domestically controlled firms to government monetary policy—for example, to use sources of credit abroad to expand more quickly when monetary policy is

expansionary—it also puts it in the position to pursue its own long-run interests irrespective of monetary policy. This flexibility also makes it more difficult for the monetary authorities to have full knowledge about the magnitude of the flow of funds through various channels and to what extent it should take action to control the money supply to meet its particular objectives at any given time.

However, too much weight should not be put on evidence that in some cases foreign controlled firms have pursued expansionary programmes during periods of credit restraint in Canada. The objective of tighter money is not to stop all investment, regardless of market prospects, but to bring about the postponement of marginal projects. The point remains, however, that the likelihood of investment decisions of foreign controlled companies (and Canadian MNE's) becoming marginal as a result of monetary policy is lower, given their size, financial independence and power. The burden of adjustment tends to be borne to a greater extent by the smaller and less powerful (and predominantly Canadian controlled) firms.

A more meaningful way of determining whether foreign owned subsidiaries tend to frustrate the objectives of Canadian monetary policy, although not an entirely satisfactory one, is to establish whether, as a group, they are increasing their rate of expansion during periods of restriction and reducing their rate of expansion when monetary conditions are eased. Table 47 indicates trends in financing by the "reporting subsidiaries" compared with total uses of funds for investment by Canadian business for the 1965-69 period. This material should be used as illustrative only; because of the

TABLE 47

INVESTMENT FUNDS AVAILABLE TO THE "REPORTING SUBSIDIARIES"*

(millions of dollars)

	1965	1966	1967	1968	1969
Current Savings (Depreciation and Retained Earnings)	1,248	1,282	1,400	1,608	1,662
External Sources					
From Canada	220	268	374	77	273
From Abroad	560	466	207	−168	80
	780	734	581	−91	353
Total Sources	2,028	2,016	1,981	1,517	2,015
Index 1966=100	100.6	100.0	98.3	75.2	99.9
Total Business Investment in Canada	7,922	9,662	9,604	9,223	9,830
Change in Non-Farm Business Inventories	+1,166	+1,026	+367	+473	+534
Total Business Requirements for Funds in Canada	9,088	10,688	9,971	9,696	10,364
Index 1966=100	85.0	100.0	92.4	90.7	96.0

*SOURCE: Department of Industry, Trade and Commerce.

lags between the raising of funds and their expenditures, too close a parallel between the two series should not be drawn. The figures appear to indicate that in 1967 the "reporting subsidiaries" had resources available for undertaking capital investment in greater volume than would have been desirable in the existing economic circumstances. The year 1967 was one of relatively tight money. There was a somewhat greater reduction in fund requirements by "reporting subsidiaries" in 1968 than might be indicated for Canadian business, as a whole, and a somewhat greater build-up in 1969. Both 1968 and 1969 were years of unusually tight credit conditions. Part of the drop in 1968 results from a net outflow of funds to foreign countries, in contrast with the more normal pattern of a substantial inflow. This reversal may, in part, be attributable to the United States balance of payments programme. While firm conclusions cannot be drawn from this table, it seems to indicate that during the period in question the "reporting subsidiaries" were moving or were in a position to move in directions which might have conflicted with monetary policy objectives.

It is important to underline that this ease of access to foreign sources of funds during times of relative credit restraint in Canada is related not so much to the fact of foreign ownership as to the size, flexibility, financial power, and international activities of the multinational enterprise. Large Canadian controlled firms, especially those with international operations, are basically in the same position in terms of access to foreign money markets in times of credit restraint in Canada. In fact, large firms, whether multinational or not, are becoming increasingly independent of monetary policy because of their ability to finance themselves through retained earnings.[38]

As pointed out in Chapter Fourteen, there is a high degree of concentration in the Canadian economy. This is particularly the case in the mining and manufacturing industries which are dominated by large multinational corporations, many of them foreign controlled. Because of the rigidities introduced by this oligopolistic structure, these firms are able to frustrate aggregate tools, such as monetary policy. The result is that the burden of adjustment is shifted on to others, namely, the less concentrated sectors, those with less market power and the non-corporate sector, all of which tend to be Canadian controlled.

Up to this point we have dealt with the impact of foreign ownership and control on Canadian monetary policy in the context of a policy of credit restraint in Canada. Similarly, when Canadian credit conditions are relatively easier than abroad (although this is unlikely to happen very often because of the extent of our integration into the world trade and payments system) other priorities within the multinational enterprise may lead to the

[38] In the context of domestic control of the national economic environment, it is relevant to note that cash flow and, to a certain extent, the size of retained earnings are related mainly to the capital cost allowance in the tax system. In other words, fiscal policy helps to provide large firms with the financial flexibility to avoid or dampen the effects of monetary policy.

withdrawal of funds from Canada. Borrowing in Canada by the multinational enterprise (whether Canadian or foreign controlled) for use outside Canada could put additional pressure on Canadian capital markets, thus increasing demand and interest rates. While this has not been a problem in the past, it could become one, especially as capital markets develop further.

Governmental pressures on the parent of a subsidiary operating in Canada may also lead to a withdrawal of funds from Canada or, at least, to a reduction in the rate of inflow. Because of the potential magnitudes involved, such behaviour could have serious impact on Canadian capital markets. For example, the United States balance of payments problem appears to have led to a shift in the structure of financing of foreign owned companies in Canada. The Department of Industry, Trade and Commerce survey of foreign owned companies shows that reporting companies reduced the proportion of their net borrowing from parents and affiliates from \$456 million, or 58 per cent of net external (capital) funds in 1965 to \$211 million or 36 per cent in 1967. There was a net return of funds to parents and affiliates amounting to \$176 million in 1968 and \$33 million in 1969. Loans of these companies from Canadian chartered banks increased by over 100 per cent during the same period (1965-69) from \$505 million to \$1,172 million. However, during the period in question *total* bank business loans were expanding rapidly. Large loans in the over \$5 million category, which is the type of loan most likely to be used by foreign controlled companies, grew nearly 300 per cent (from \$994 million to \$2,756 million) and thus the effect is not perhaps as dramatic as at first sight appears. Nevertheless, it would seem that the United States balance of payments problem has tended to bring foreign controlled subsidiaries closer to the Canadian commercial banking system and, if anything, made them slightly more subject to the influence of Canadian monetary policy.

In certain circumstances, the objective of monetary policy can be more short-term and specific, such as to defend the exchange rate—as in the period November 1967 to May 1968. While speculative flows were the main source of the problem, the multinational enterprise, whether foreign or Canadian controlled—with its large volumes of intracorporate flows—was in an excellent position to add to these speculative flows and to increase downward pressure on the dollar. The problem was probably greater in the case of foreign controlled MNE's only because there are more of them and they tend to be larger. The response of United States controlled subsidiaries to the United States balance of payments programme, especially during the first few months of 1968 (prior to the exemption for Canada), indicates that Canadian vulnerability is increased because these companies may respond to requirements of foreign laws, policies or regulations.

It would be misleading, however, to exaggerate the leakages that result from the high degree of foreign ownership and control of Canadian corporate business, or the existence of the MNE regardless of its ownership.

Very sizable capital flows occur in other than the corporate sector, with a large volume of foreign borrowing being done by the provinces, municipalities and their agencies. Furthermore, the emergence of an international capital market serving both long- and short-term needs has introduced considerable flexibility into company financing. Large Canadian owned corporations are familiar with this market and use it. Small Canadian owned companies also have some access to it through dealers who know the international money market. The Porter Commission on Banking and Finance confirmed this conclusion.

CONCLUSIONS

In summary, it appears that leakages—which complicate the effectiveness of Canadian monetary policy—occur as a result of the integration of the Canadian economy with the world economy (including both trade flows and capital markets), rather than as a result of the degree of foreign control of Canadian business. Foreign control does not appear to have been the major cause of the openness. To some extent there may have been an element of reciprocal causality (openness leading to foreign control leading to greater openness), but by and large the openness of the Canadian economy to trade and foreign investment seem to have had the same basic determinants (see Chapter Three). It follows that the impact of foreign ownership and control on Canadian monetary policy can probably be characterized as marginal.

Where there is an economic situation involving a balance of payments surplus, coupled with an unacceptable level of unemployment, two points emerge. Firstly, it is incorrect to suggest that Canada could not afford to block capital inflows (as distinct from other elements that may accompany them) at a time of high unemployment. Further net inflows could cause the exchange rate to appreciate and raise the price of exports relative to imports, with consequent adverse effects on employment. To the extent that adjustment takes place through an increase in the level of reserves, it would probably lead to an increase in the money supply (since it is unlikely that the monetary authorities would wish to raise the general level of interest rates). A capital inflow which increases the money supply makes sense where levels of employment are not satisfactory. It is less sensible from a balance of payments and savings perspective. Our current account is now in surplus, indicating that a net shortage of savings is not a Canadian problem at the moment.

Secondly, from the perspective of domestic control of the national economic environment, it may be better in these circumstances to limit the capital inflow and allow monetary policy to be determined by domestic requirements, rather than have that policy determined by the need to respond to the capital inflow.

Both of these points would, of course, have to be modified if the foreign inflow can do more to increase employment than the use of the same amount of capital by Canadians because of the concomitant introduction of technology or some other advantage. This would only apply if it were not possible to separate the capital inflow from the acquisition of the technology or other benefit. (The advantage may, in fact, stem from the provision of capital itself if the amount required for a particular undertaking cannot be readily mobilized in Canada, but this need could be reduced if intermediation in capital markets is improved in line with the suggestions outlined in Chapter Six.) In these circumstances, an argument can be made for looking carefully at investment inflows on a case-by-case basis to determine whether they bring with them something otherwise lacking in the economy that would lead to increased activity, rather than simply displacing activity by Canadian controlled enterprise. A financial inflow unaccompanied by any other benefits would not seem to be appropriate in circumstances of a current account surplus and unsatisfactory levels of employment.

Takeovers of Canadian firms by foreign interests in the economic circumstances which have existed recently provide a good example of this point. When these takeovers occur, the resultant capital inflow (assuming foreign and not Canadian capital is being used) has to be taken into reserves. Otherwise, the inflow leads to upward pressure on the Canadian exchange rate with adverse effects on export- and import-competing industries. In order to maintain the exchange value of the Canadian dollar, the government purchases the foreign currency offered in connection with the takeover by running down its cash reserves, by borrowing, or by employing tax revenues. But the cash needs of the government in financing the exchange transaction are the same as if it had raised the money to finance the foreign takeover of the Canadian firm. Such takeovers can only be justified in economic terms if the foreign buyer is bringing something new to the Canadian economy which would either increase industrial efficiency, employment, or other benefits.

Chapter Sixteen

EXTRATERRITORIALITY—THE IMPACT OF CERTAIN FOREIGN LAWS AND POLICIES ON THE BEHAVIOUR OF CANADIAN FIRMS

INTRODUCTION

Foreign laws and policies can affect Canadian firms in four basic kinds of circumstances:

(i) Where the Canadian firm is part of an international structure and an affiliate which is located in a foreign jurisdiction is instructed by the authorities in that jurisdiction to behave in a manner which affects the Canadian firm. This can occur where the firm is Canadian controlled or foreign controlled. This would apply, for example, in the case of a United States directive issued under its balance of payments programme affecting the flow of funds out of the United States.

(ii) Where a Canadian firm's affiliate in a foreign jurisdiction is instructed by the authorities of that jurisdiction to require the Canadian firm to do or refrain from doing certain things. This, too, can affect Canadian controlled and foreign controlled firms.

This would apply in the case of a United States directive under the balance of payments programme instructing a United States firm to have funds transferred to it from its Canadian subsidiary. Further examples are the application of United States anti-trust decrees against a United States firm—or a Canadian firm having a United States subsidiary—instructing that it have the Canadian firm comply with the order, or the provisions in the *Trading with the Enemy Act* prohibiting firms controlled by United States persons or companies from trading with certain countries.

(iii) Where a Canadian firm having no international affiliation is obliged to accept particular undertakings as a condition of entering certain international transactions. A Canadian acquiring goods or technology originating in the United States could be required to accept certain restrictions on the re-export of those goods or technology under the legislation of the United States and similar legislation

in Canada. United States securities legislation may also have a similar impact.

(iv) Where a Canadian corporation having no international corporate affiliation or transactions with the jurisdiction involved is inhibited from undertaking certain activities because of restrictions imposed by a foreign government on the conduct of its nationals who are involved with the Canadian corporation. An example is the *Trading with the Enemy Act* prohibition against United States nationals involved with a Canadian controlled company dealing with the nationals of certain other countries.

Some of these circumstances constitute the direct extraterritorial application of a foreign law, as in the case where the law directs a Canadian firm to do or refrain from doing something, even though there is no voluntary or actual contact between the Canadian firm and the foreign jurisdiction. In other cases, a law applied by a foreign country within its own jurisdiction can have indirect extraterritorial effects on Canadian firms by virtue of the activities of international commerce. This would be the case, for example, where a Canadian firm was given access to United States technology only on a condition it was not made available to a communist country.

Any jurisdiction needs to be concerned about behaviour beyond its own borders because of the way in which international business structures and commercial transactions can affect the implementation of domestic policy. There is nothing unique about the extraterritorial application of United States laws, although their impact beyond the national borders of the United States may be more far-reaching than is the case with the laws of most other countries. Failure to follow some activities beyond domestic borders would permit domestic policies to be easily and flagrantly circumvented. This is particularly so when the foreign activity has no apparent purpose other than to evade the impact of a domestic law, although the problem can also arise from foreign operations which have a commercial or other purpose of their own. In such cases, the laws and policies of the two jurisdictions may be in conflict.

Canada's exposure to these problems is substantial because of the high degree of foreign investment and international commercial transactions—particularly with the United States. As a matter of principle, Canada has a right to exercise full control over activities which occur within its borders—and should assert this right. The direction of behaviour within Canada by foreign governments offends this principle. However, full assertion of this territorial sovereignty cannot get at some policies of foreign governments, which are aimed primarily at affecting the domestic activities of firms or persons in their home jurisdiction but indirectly can have an impact on Canada. Only a reduction of Canada's international exposure or international arrangements can neutralize these latter effects.

The assertion of jurisdiction by Canada can also include the co-operation of the Canadian government in permitting foreign authorities to investigate

the behaviour of foreign affiliates in Canada and direct its cessation or modification in certain cases. Similarly, Canada may want to examine certain behaviour of companies outside the country in pursuit of its domestic policies. The extent of international movement and activities of persons, assets and businesses requires such co-operation if domestic laws are not to be frustrated. Such an accommodation of the interests of a foreign government is itself an exercise of the Canadian sovereign right to control activities within its borders.

In some cases, Canadian interests may not be served by allowing foreign authorities to direct firms in Canada to conduct their affairs in a certain way. Foreign orders of that sort ought to be blocked by the Canadian government under those circumstances.

In some cases, it may be best to block the application of a particular foreign law or policy entirely by preventing certain actions from taking place in Canada. On other matters, no Canadian legislative action may be necessary if the activity involved is not a matter of concern. In still other cases, inter-governmental co-operation might be in order—or techniques for differentiating the offensive from the acceptable directions emanating from a foreign authority ought to be established.

This chapter will examine five areas of concern to Canada over the years. All of the instances selected deal with United States legislation and policies. They are the *Trading with the Enemy Act,* the *Export Administration Act* (formerly the Export Control Act), antitrust legislation, securities legislation and balance of payments policy.

There are numerous other areas where the policies of different countries come into contact—and sometimes conflict—which are not dealt with here, such as tax administration and criminal law jurisdiction. A considerable degree of international co-operative action has developed in these areas, which might provide useful models for handling conflicts of the sort considered in the following discussion.

TRADING WITH THE ENEMY ACT

THE LEGISLATION

Any exportation or trading with Cuba, China, North Korea and North Vietnam is subject to prohibition when undertaken by persons subject to the jurisdiction of the United States courts. Section 5(b) of the *Trading with the Enemy Act* of 1917 empowers the President or his nominee "during the time of war or during any other period of national emergency declared by the President" to investigate, regulate or prohibit all commercial and financial transactions by Americans with certain foreign countries or the nationals of such countries.

On December 16, 1950, when the Chinese entered North Korea, President Truman invoked his powers under this legislation and assigned

responsibility for this application to the Treasury Department in the Office of Foreign Assets Control. This Office has required a licensing of commercial transactions by United States persons or firms (including affiliates or subsidiaries of United States persons or firms) with the governments or nationals of China, North Korea and North Vietnam.

Similar transactions involving Cuba are governed by the Cuban Assets Control Regulations, established under authority of the same legislation.

Exports of strategic materials by foreign affiliates or subsidiaries of United States persons or firms to Russia and all countries of Eastern Europe (other than Yugoslavia) are controlled by the Transaction Control Regulations. The commodities included on this list parallel closely the COCOM list (the list drawn up by the Coordinating Committee, a group made up of all the NATO countries other than Iceland and Japan). This is in addition to the other controls applied to munitions exportation by United States controlled subsidiaries.

Unlike the *Export Administration Act* controls considered later in this section, the Treasury Department authority under the *Trading with the Enemy Act* is not dependent on the goods or technology having originated in the United States. The rules are applicable directly to exports made by foreign subsidiaries or affiliates of United States persons or firms. The critical issue is that of the degree of connection to the United States which is regarded as necessary to activate these rules—the rules being applied regardless of the origin of the technical data or components or the location of the manufacturing. It is not relevant legally to the United States authorities whether the goods involved are validly made under Canadian law and shipped abroad under a Canadian export permit. Indeed, even activity undertaken by United States controlled firms in Canada with the support of the Canadian government becomes subject to these export limitations—the sanctions for violations being imposed on those within the reach of United States authorities who have "control" over the subsidiaries or have participated directly.

In principle, fifty per cent United States ownership is regarded as sufficient to establish a controlling position of an American firm over a Canadian subsidiary, even though the majority of directors are not American. The United States shareholders and directors are expected to exert influence over the companies' activities, and are liable for violations. The United States regulations may also be invoked when real control rests in the hands of Americans, although they have less than fifty per cent ownership.

The application of the regulations in relation to China was eased first on December 19, 1969. From that date on, United States subsidiaries and individuals could trade with China provided that no United States dollars, United States vessels, United States goods, United States technical data, nor strategic goods (regardless of origin) were involved—and provided that the transactions were "incident to the conduct of business activities abroad engaged in by any individual ordinarily resident in a foreign country in the

authorized trade territory, or by any partnership, association, corporation or other organization which is organized and doing business under the laws of any foreign country in the authorized territory". Canada is included in the "authorized territory". This relaxation of the rules did not apply to dealings with North Vietnam or North Korea.

On April 14, 1971, President Nixon announced his intention to further modify these rules regarding China. This would permit the use of United States dollars in transactions with China; permit United States oil companies to provide fuel for ships or aircraft proceeding to or from China (except Chinese owned or chartered carriers going to or from North Vietnam, North Korea or Cuba); permit United States vessels or aircraft to carry Chinese cargoes between non-Chinese ports and to enter Chinese ports; permit Americans and United States controlled firms to ship certain non-strategic goods to China under general licence.

This step would remove some of the restrictions against United States controlled firms dealing with China. Furthermore, the Chinese are still reluctant to deal with United States controlled companies—and have expressed some reservations about dealing with firms whose effective control is in Canada but which have substantial American holdings.

Ostensibly, Cuba has also been the subject of a modified set of rules. A general licence has been issued which allows foreign companies (other than banking institutions) owned or controlled by United States persons or firms to trade with Cuba in foreign-origin goods located outside the United States—provided that neither United States dollars, nor transport by United States interests, nor exports are involved. There is, however, an important qualification to these modifications which virtually nullifies their significance. This section expressly "does not authorize any *person* subject to the jurisdiction of the United States to engage in or be involved in any transaction". This has been interpreted so as to preclude all United States citizens from participation. As a result, while a United States subsidiary technically would be allowed to deal with Cuba, Americans on its board of directors would not be permitted to do so, which could effectively block the company from dealing with Cuba. In fact, even Americans on the board of a wholly Canadian controlled company would appear to be subject to the prohibition with regard to Cuba.

Trade of the types described above can only take place under the authority of a licence issued by the Office of Foreign Assets Control. It is on the issuance of licences to Canadian firms that most of the discussions between the two governments have taken place.

APPLICATION OF TRADING WITH THE ENEMY LEGISLATION

Aside from regulations under Canada's *Export and Import Permits Act,* which require permits for the *re-export* of goods generally and restrict the movement abroad of strategic goods from Canada, trade with the countries

covered by the United States *Trading with the Enemy Act* is neither prohibited nor subject to licensing under Canadian law. In applying the Canadian law requiring licensing of United States re-exports from the country, Canada has undertaken to prevent the re-export of United States goods from this country in cases in which the United States regulations would prevent initial export from the United States. Thus, while Canadian trade with Cuba and China in non-strategic goods is not restricted, the export of United States-origin goods must be licensed, and generally will not be approved. The Canadian authorities do not examine the export of Canadian-origin goods to China and Cuba, so that steps by United States authorities to block this category under the *Trading with the Enemy Act* trade is not part of any voluntary undertaking by Canada in return for some other favourable considerations from the United States involving trade regulations.

Under the *Trading with the Enemy Act,* United States authorities seek to prevent the export of Canadian goods to prohibited countries not only in cases where the commodity itself has some link with the United States, but also in cases where the United States has some link to the Canadian company itself—either through controlling shareholdings by United States citizens or through United States citizens involved with the company. (This contrasts with the United States *Export Administration Act,* discussed in the following section of this chapter, which is concerned only with United States links with goods, rather than with companies.) This kind of restriction, therefore, may affect the export of goods that is entirely Canadian in origin, which is probably the most offensive aspect of United States export controls.

It is this category of exports of Canadian made goods, with little or no United States content, to which Canadian representations have been most strongly directed.

In 1958, an agreement was reached between Prime Minister Diefenbaker and President Eisenhower. The statement made by the Prime Minister recorded an understanding that "United States regulations should not be applied in any way to the disadvantage of the Canadian economy. If cases arose in the future where the refusal of orders by companies operating in Canada might have any effect on Canadian economic activity, the United States government would consider favourably exempting the parent company in the United States from the application of the foreign assets control regulations with respect to such orders."

In line with this understanding, United States-Canadian discussions have taken place on certain applications—and the United States government has on a few occasions granted permission to the United States parent to permit the Canadian subsidiary to make the sale. Frequently, the shipment never actually occurs after permission has been granted, perhaps due to less open United States pressures being brought to bear on the parent. In some cases, discussions are launched regarding a possible sale, but permission is never issued. The criteria applied are understood to be the significance of the export to the Canadian economy and the availability of other Canadian firms to fill

the order which would be able to do so without violating the United States legislation.

Canadian experience under this scheme—regarding both China and Cuba—has not been extensive. Firms subject to the legislation presumably do not actively seek sales in these markets and probably are concerned about the adverse publicity which might affect them in the United States if the sale were undertaken, and in Canada if it were blocked. Requests made by would-be purchasers in countries to which sales are made difficult by these rules may never actually come to the government's attention.

The Merchant-Heeney Report of June 1965,[39] paragraph 61, stated that: "It is important that each country should avoid efforts, or apparent efforts, to extend its domestic law into the territory of the other. A case in point . . . the administration of foreign assets control under the United States *Trading with the Enemy Act,* as it relates to United States owned branches and subsidiaries domiciled in Canada, occasionally comes into conflict with the laws, regulations and policies of the Canadian government. We strongly recommend that the two governments examine promptly the means, through issuance by the United States of a general licence or adoption of other appropriate measures, by which this irritant to our relationship may be removed, without encouraging the evasion of United States law by citizens of the United States".

These recommendations may have led to some softening of the United States position, but aside from the rules noted above regarding China, there do not appear to have been any changes in the content of the policy reflecting Canadian concerns on this subject.

The extent of the informal enforcement by American authorities is not really known, but one cannot rule out the possibility that persuasion is used with United States parents to influence the behaviour of subsidiaries.

It is not possible to make any economic assessment of the effects of this extraterritorial impact of the *Trading with the Enemy Act*. Indeed, one could argue that Canadian firms have had the advantage of access to the markets of China and Cuba without competition from United States firms, thus establishing a net benefit to Canada, but that remains a matter of speculation.

POLICY ALTERNATIVES

It is not difficult to understand why the United States should wish to prevent blatant violations by Americans setting up non-operating firms in Canada solely to circumvent its rules. But this United States law has also restricted Canadian activity based largely, or even entirely, on Canadian commodities, technology and manufacture. This raises very different issues. The high degree of United States control of Canadian business makes it particularly vulnerable to this sort of United States influence. Should the United States hold persons over whom their courts claim jurisdiction liable for such

[39] Canada and the United States: Principles for Partnership.

transactions—and if those persons have effective authority over firms operating in Canada—the alternative possibilities for a Canadian policy which seeks to offset this extraterritorial influence (short of severing the links with the United States parent) are to:

(i) impose a counter-liability on persons operating the Canadian firm, who are subject to Canadian jurisdiction, if they submit to United States authority;

(ii) attempt to force an export sale prohibited by the United States by confiscating or purchasing the goods under mandatory provisions and reselling them to the buyer in the prohibited market; or

(iii) protest to the United States in an attempt to forestall action on its part which is contrary to Canadian interests.

The proposed Competition Act contains a provision prohibiting Canadian firms from refusing to enter into export transactions by virtue of the law of foreign jurisdiction where the result of such a restriction adversely affects competition, efficiency or trade. The proposed Act would prohibit the restriction of exports in compliance with the laws of a foreign government. The impact of this legislation cannot be expected to be too great, since the securing of evidence poses administrative problems. It may be difficult, if not impossible, to establish that an offer to purchase by a foreign buyer in a prohibited market amounts to a firm order from the supplier. To prove the offence, it would be necessary to establish that a firm order existed—not simply a "feeler" or an attempt at harassment of a United States controlled firm in Canada. The failure to accept an order may be explained by a variety of factors unrelated to the United States law, such as an inadequate capacity to fill the terms of the order or unsatisfactory payment terms.

This approach based on prohibition has some value in cases that can be proved. It could not, however, be expected to deal generally with the problem. Nor could this approach be expected to lead to any aggressive marketing by foreign controlled firms in the markets involved. It would, however, serve as an indication of the Canadian government's policy. It might also help provoke some modification of United States policy under the urging both of firms having subsidiaries in Canada which would be exposed to this legislation, and firms in the United States which would lose export markets to firms happening to have subsidiaries in Canada.

The forcing of a sale through a governmental purchase of the goods in question could be considered as a general policy or as one which would arise as a specific performance remedy for cases found to have violated the proposed Competition Act provisions outlined above.

However, the degree of direct government involvement here would impose on it the obligation of assuming responsibility for payment. It could also lead the purchasing countries—which are largely central planners—to press this agency to have Canada buy more from them in return for the export sales.

In the case of a forced sale by a Canadian subsidiary in compliance with Canadian law, the United States authorities might not enforce their own legislation against the parent company. This procedure would require the establishment of an agency to determine whether the order is *bona fide,* or simply a means of harassment by a foreign country, prior to invoking the public authority to force the sale. Similarly possible, the legitimate business reasons for the refusal by the firm to make the transaction could be considered by the agency in advance of any forcing of the sale.

It would be awkward for the government, however, to have to involve itself this directly and to have to assume the business risks of the transaction. Furthermore, while the prohibitive approach of the proposed Competition Act sets out government policy, it limits the offence only to a refusal to enter a deal because of the prohibition of a foreign law. A refusal based upon the marketing strategy of the firm would not be an offence. If a Crown agency was established, the government might be under pressure to force the Canadian subsidiary to sell to it. Under such circumstances, however, it might be reluctant to do so.

The lodging of a protest with the United States over this issue would be a renewal of earlier complaints and might be made to appear as a request by Canada for a "concession", rather than as an assertion of its authority over business taking place in Canada. This approach could give rise to public criticism. Furthermore, if the United States were to make modifications, there might be a tendency to seek, however subtly, a reciprocal consideration from Canada—perhaps in other aspects of policy which are of considerably greater economic and social significance for the country. This could occur despite the fact that United States policy is moving in the direction of liberalizing trade with China and other communist countries for reasons of its own.

A special modification of United States law applying to United States subsidiaries in Canada—but not elsewhere—is unlikely, since United States corporations which would then be discriminatorily denied access to certain markets would object.

What role, if any, could a review process play in lessening the extraterritorial effects of foreign laws? To the extent that a review process is authorized to examine particular forms of foreign direct investment, it could identify export restrictions or opportunities available to a particular foreign controlled firm. The existence of export restrictions—whether arising from corporate policy or foreign law, including restrictions arising from balance of payments policies of other countries—would constitute a disadvantage which might be taken into account by the review body. Both the possibility of Canada ultimately relying less on foreign controlled companies in many industries, and the disfavour of the review authorities for export restrictions, could lead to a search for sources of foreign direct investment or production inputs which would not act as a conduit for the extraterritorial application of foreign laws to Canadian companies. This might reduce the adverse impact of these provisions on Canadian trade—and potentially cause some pressure to be put on

United States authorities by corporations seeking to operate in the Canadian market. This would not, however, serve to alter the potential impact of current laws on existing United States companies in Canada.

CONCLUSIONS

The approach contained in the proposed Competition Act asserting national jurisdiction over Canadian business and trade is a partial step, but it would not cover many of the impediments to trade with certain countries. A review agency, similarly, would have only a limited effect in offsetting the impact of foreign law in this area. Nevertheless, the assertion of Canadian jurisdiction would have a certain symbolic value and possibly some practical effects.

The attempt by foreign countries to prohibit trade by Canadian firms with certain countries which is sanctioned by Canadian law is the most politically offensive of the examples of extraterritoriality. It permits constraints, under some circumstances, despite 100 per cent Canadian content of the goods involved. Although the economic significance is not likely too great—particularly if trade with China in non-strategic goods becomes possible through United States controlled subsidiaries—the political impact on the Canadian public may be significant.

THE EXPORT ADMINISTRATION ACT AND CANADIAN EXPORT CONTROL POLICY

THE LEGISLATION

The United States Department of Commerce, through its Office of Export Control, exercises authority under the *Export Administration Act* of 1969 (the somewhat liberalized successor to the legislation begun as the *Export Control Act* of 1947) to require licences of different kinds for all exports of commodities and technical data. Canada is basically exempt from this requirement for imports which are *destined for use or consumption in this country*. This exemption for Canada by the United States is unique.

The exports to Canada which remain under control relate to nuclear weapons and power devices, arms and ammunition, and other items such as gold, narcotics, natural gas, electrical energy, watercraft, tobacco seed and plants. Various conditions and assurances are required for a number of these exports. Prominent among the conditions for the strategic items is a written assurance against re-export.

Goods exported to Canada from the United States for re-export are subject to essentially the same restrictions as exports directly from the United States to those various export points. In the case of exports which can move from the United States under "general licence", re-exports of United States goods from Canada can proceed without securing any further

American clearance. In the case of certain goods and technical data destined for designated countries which require "validated licences" (i.e., specific authorization for each export order based on declared destination), the approval of the Office of Export Control is technically required. Canadian authorities, however, require permits for re-exports under regulations that basically apply the United States rules. If there is reason to believe that the Office of Export Control might not be in accord with such an export, the authorization of that Office is sought before a Canadian permit is issued.

In the case of exports from the United States requiring validated licences, the American authorities consider the particular consignee, the country and the intended use. Such licences will only be issued to a United States exporter trans-shipping through Canada or to a United States agent for the Canadian consignee if he assumes responsibility, since he is within the jurisdiction of the United States. A variety of conditions apply to different exports and countries. Basically, these regulations apply to exports to communist countries—excluding Yugoslavia.

Generally, the United States provisions are becoming less restrictive over time, but they are still significantly different from those of Canada. Furthermore, their rules regulating re-exportation from Canada go beyond the direct trans-shipment of goods in their original form. The United States follows components and technical data (either embodied in commodities or separately) through levels of reassembly and manufacture in Canada in order to control their re-exportation.

The United States regarding re-export are technically binding on "any person", regardless of citizenship or residence and the legality of the acts in question in the jurisdiction of their occurrence. While fines and imprisonment are provided for following conviction in the courts, administrative sanctions are most common. The basic penalty is the rather severe economic sanction of an "order of denial of export privilege". United States exporters are denied the privilege of exporting and importers abroad are denied the opportunity of being associated with export transactions from the United States by virtue of a United States order prohibiting United States exporters from dealing with such persons.

Canada has export laws of its own which reflect its views of strategic considerations and, as already indicated, it cooperates with the United States as a condition of securing free access to goods and technology from United States sources.

To begin with, Canada has participated in an informal grouping of NATO countries, excluding Iceland, plus Japan (Co-ordinating Committee for Consultative Group—International Export Controls, East-West Trade—COCOM), which provides a form of international regulation of trade in strategic goods by member countries. The items which members regard as "strategic" are not to be exported to the Sino-Soviet Bloc.

Since 1947, Canada has had an *Export and Import Permits Act,* under which regulations are issued to restrict the movement of strategic goods and

to implement intergovernmental arrangements. The Act has also been used to ensure an adequacy of supply in Canada of articles for defence or other needs. The Export Control List designates the commodities under surveillance and the Area Control List designates the countries for which all exports require permits. Permits may be granted for the export of goods from Canada to countries on the Area Control List or for goods on the Export Control List to any country.

Under this legislation, the re-export of goods originating outside of Canada requires licensing. While this provision is not limited to re-export of goods from the United States, it relates to such goods in most cases. This provision in the Canadian law reflects our special relationship with the United States and our interest in co-operating with the United States so that imports into Canada from the United States may remain free of American licensing requirements. Thus, in addition to fulfilling our COCOM undertakings, Canada itself will not allow United States controls over known United States-sourced goods to be frustrated by diversion through this country. In general, Canada will not issue permits for the re-exportation of United States goods if the United States rules do not permit it. Failure to comply with these requirements of securing a Canadian licence constitutes a violation of the Canadian regulations.

APPLICATION OF THE UNITED STATES EXPORT CONTROLS LEGISLATION

Areas of conflict between the administration of the Canadian rules and those of the United States do exist. In such cases, United States authorities would apply their rules directly to exports from the United States, rather than rely on Canada to control any re-exports.

Canadian controls apply to commodities and to technical data in a physical form (e.g., technical drawings) which have a value of over $50.00. No attempt is made in Canada to control the export of technical data or know-how in the minds of skilled personnel. The American rules do purport to cover such exportation. In this area the United States rules would apply directly, since Canada does not require re-export permits. (Technical data which are "published" or generally available to the public are not subject to this set of controls in either country. Patented technology is regarded as being "published".)

The enforcement of this provision has been extended by the United States authorities to include lawfully acquired United States "know-how" contained in the minds of United States citizens when applied in employment outside the United States. This would cover United States citizens working in research and development work for a firm in Canada—regardless of whether that firm was United States owned or controlled.

A further area for direct application of United States controls would emerge when United States components are involved in Canadian manufactured goods. Canada exempts from control the re-export of goods (excluding the strategic category of commodities) which, despite being partially of

non-Canadian origin, "have been further processed or manufactured in Canada, by combining them with other goods or otherwise, so as to result in a substantial change in value, form and use of the goods or in the production of new goods . . . ". There is scope for differing views between Canadian and American authorities as to whether the original national identity has been lost. If the United States government rejects Canada's contention that a permit is not required for a particular product because of the extent to which it has assumed a Canadian identity, the United States authorities may claim the applicability of their rules and impose consequent sanctions, such as "blacklisting" of the Canadian manufacturer involved.

The point at which United States national identity is lost in the eyes of American authorities is unclear. If a component is actually incorporated, the final commodity is liable to come under United States controls, regardless of the minor nature of the component in the completed item. Similarly, the mixing of United States-sourced technology with Canadian or other know-how is not necessarily regarded by the United States Office of Export Controls as eliminating its national origin.

Where there is no re-exportation involved, and the commodity is not otherwise restricted under the Canadian Export Control List, no licence is required by Canadian law. Exports of Canadian goods to Cuba, for example, would not have to be licensed—nor Canadian authorities otherwise advised. If, however, some re-exportation of United States goods is involved, Canadian authorities would refuse to issue a licence for a sale to Cuba. If Canadian authorities considered that no re-exportation was involved in a particular case, they would not prevent the transaction.

The United States authorities, however, might act directly to prevent such a transaction—basing their move on the Cuban Assets Control Regulations.

The extensive reliance of Canadian industry on United States origin goods and technology creates substantial scope for the application of these re-exportation provisions. The existence of substantial United States control over Canadian manufacturing and the known propensities of Canadian subsidiaries of United States parent firms to import from parents and their home economy widen the range of goods and technology whose re-exportation is subject to licensing and perhaps restriction. In either case, the United States trade policy determines the minimum restrictions on exports by Canadian firms in such circumstances. This applies to both foreign controlled and Canadian controlled firms securing components and technology from the United States.

While most countries exercise some control over the export of strategic goods and related technological data, the United States traditionally has used its international trade policy for the broader purposes of its international policy. Based on its strength as an exporter of commodities and know-how, the United States has attempted to create an economic disadvantage for countries to which it is hostile. To enforce this policy, the United States

has prevented United States exporters and foreign importers (whether United States controlled or independent) from using foreign locations for the purpose of trans-shipping United States-origin goods and technology.

The economic significance of the constraints imposed by United States export controls cannot be readily assessed. Information regarding the frequency of refusals of export permits and the volume of trade thereby affected has not been collected by the Canadian authorities. Furthermore, the trade impact of voluntary compliance or persuasive enforcement by United States authorities which never comes to the attention of the government goes unrecorded. The total trade constraint which emerges from these controls and the extent of additional export trade in manufactured goods which might otherwise occur from Canada are matters for speculation at the present time. Very few Canadians have been "blacklisted",[40] nor have many Canadians been prosecuted in Canada for violating Canadian export controls.

Complex administrative steps are avoided in trade between the United States and Canada as a result of the co-operative arrangements between the two countries. Components and technology for domestic use in Canada enter freely, since Canadian authorities have undertaken to police their re-export. The Canadian authorities apparently attempt to help Canadian exporters to do everything they can within these rules. The Canadian authorities might help a Canadian prepare his case for presentation to the United States authorities. Where the authorities consult directly, they attempt to mask the details of commercial intelligence significance. Furthermore, the United States authorities claim that the United States manufacturer is not consulted or informed as to a potential export sale for a Canadian firm re-exporting United States goods. Whether United States manufacturers find it more or less convenient to export from Canada by virtue of these arrangements and the ultimate need to comply with United States policy is not known.

There are a number of cases in which United States *Export Control Regulations* have impeded Canadian exports. As in the case of the *Foreign Assets Control Regulations,* issued under the *Trading with the Enemy Act,* there are likely many cases which do not even come to light because the subsidiary is aware of the likely reaction of the United States government.

Unlike the potential application of the *Trading with the Enemy Act* to commodities originating entirely in Canada, these export controls apply where some American content is involved. While the degree of United States content might be minor—or its form, value or use substantially altered in the view of Canadian authorities—there is some United States real input or technological know-how at issue. The access for Canadian manufacturers to such inputs for their domestic operations is of value—and the avoidance of

[40] A published United States denial list of firms of close to sixty pages includes only four Canadian operators. Three of these are no longer in Canada—having located in Canada, apparently, with the principal objective of circumventing the U.S. law or for exploiting a particular opportunity. These are not well-known firms. This would seem to reflect a high degree of compliance.

complex administrative procedures with United States authorities is a genuine convenience. Nevertheless, other countries do manage without such special treatment.

POLICY ALTERNATIVES

There are two economic issues at stake—free and easy access to United States components and technology for domestic manufacturing and markets; and opportunity for Canadian manufacturing (Canadian or foreign controlled) to pursue export markets constrained only by Canadian international trade policy. Although this legislation has not been a subject of wide public debate in Canada, unlike the *Trading with the Enemy Act,* there is the political and symbolic issue of the constraints imposed on activities in Canada through United States policies.

In the final analysis, a determined United States government can—as could any government—attach whatever conditions it wishes to exports from its industry. Even in the absence of Canadian co-operation, the United States could simply and would likely deny exports to Canada unless adequate assurances were made against offensive re-export. Whether the United States would be prepared to forego access to Canadian markets, what the nature of pressures from United States firms having Canadian subsidiaries would be in Washington and what the tone of United States public opinion would be on this issue if Canada were to refuse to co-operate in the application of such restrictions is not clear. The problem would be diminished to the extent that there is a reduction of Canadian dependence on United States-origin components and technology.

The alternative policies open to Canada on this issue are not unlike those identified earlier with regard to restrictions arising from the United States *Trading with the Enemy Act.* These are to:

(i) prohibit the restriction of exports from Canada by reason of a foreign law and prohibit the giving of assurances to that effect;

(ii) force blocked sales to export markets by governmental purchase for resale;

(iii) attempt to secure a modification of United States policies in this area;

(iv) discontinue the Canadian policy of applying United States export rules through Canadian re-export licensing regulations;

(v) take steps to reduce Canadian reliance on United States inputs by encouraging recourse to alternative sources.

The first approach is embodied in the proposed Competition Act. It could be unlawful, subject to its impact in Canada, for any person or corporation in Canada to restrict export trade pursuant to the laws of a foreign government or to meet the requirements of a foreign source acting under the laws of a foreign country.

This would not affect cases covered by the re-exportation provisions of the *Export and Import Permits Act,* since it is a Canadian law. Only a repeal of the re-export provisions of this Act would bring it under the new prohibition.

This approach has some disadvantages. Firstly, the securing of evidence to enforce a prohibition under the proposed Competition Act could be difficult —especially since there are likely numerous unapparent restrictions on exports as a result of the United States legislation. It would, furthermore, be difficult to distinguish restrictions based on foreign legislative provisions from those emerging from corporate marketing strategy. Secondly, American authorities could apply the provisions of the legislation by requiring an assurance against unlawful trans-shipment from the United States exporter. In the case of parent-subsidiary trade, the exporter might be able to be held effectively accountable—and be able to implement the undertaking without issuing express directives to the subsidiary. Alternatively, the United States authorities could deny access for Canadian manufacturing firms—particularly those owned by Canadians or non-United States-foreigners—to United States goods and technology.

The potential value of this approach would lie in the pressure it would bring to bear on United States authorities from the exporters, who have a vested interest in easy access to the Canadian market. Public opinion in both the United States and Canada might further bolster this pressure. Some intergovernmental resolution might then evolve.

On balance, this alternative of prohibiting the restriction of exports by reason of a foreign law is not too promising. The United States government is unlikely to modify its rules solely because of Canadian attitudes expressed in this way. If it were, however, prepared to relax its rules for various reasons, the change could be portrayed by the United States authorities as a United States "concession" to Canada and could be suggested as deserving some reciprocal concession. Whether a relaxation of the present rules would significantly expand Canadian exports is by no means clear. The motives for a parent to constrain a Canadian subsidiary from exporting are potentially numerous. So long as the restrictions remain, however, some impact is probably in effect—and would limit the capacities of the review authorities to expand manufacturing exports of United States controlled firms making use of parental inputs.

The second alternative approach, that of forcing of export sales through a governmental agency making the purchase for resale, was considered in the discussion of the *Trading with the Enemy Act*. It is less appropriate, in the case of this legislation, since there would be far more instances of restrictions. Furthermore, the expansion of exports significantly requires an aggressive international marketing effort, not simply a response to particular foreign orders.

The third general approach of negotiating for a modification of the United States rules poses issues similar to those dealt with in regard to the

Trading with the Enemy Act, that of "asking" the United States for a concession. In the case of the *Trading with the Enemy Act*, however, there is probably a greater affront to Canadian sovereignty and policies, in that it can affect activities having no United States inputs. Here we are dealing with matters where some United States inputs do necessarily exist.

There may, however, be some more obvious issues for negotiation, such as the degree of transformation of an original United States component or element of technology, and the proportion of the total value or significance of the unaltered component in the final product required to avoid the application of United States rules. At the moment, the aspect of transformation is subject to case-by-case interpretation to determine whether some new product emerges. The second aspect—the proportion of the total value or significance of the unaltered component—is not currently used as a criterion. If the component remains intact, the relatively small proportion of the total value of the end product which it constitutes is apparently irrelevant in the eyes of United States authorities. This is partly because the input might be of great significance, despite being a relatively unimportant component of the total value. The Canadian formula regarding "a substantial change in value, form, and use . . . or . . . the production of new goods . . . " does not involve this criterion either.

Attempting to improve the formula through the proportion of value added is potentially cumbersome. Any formula regarding percentages of value added would pose some administrative complexities. The applicant would have to record and value all inputs. The assessment of the value added by non-purchased and perhaps intangible inputs is difficult and rules would be needed to determine the proper treatment of "mark-ups", transportation costs, packaging, etc. A fixed formula related to the percentage of value added would probably have to be subject to some exceptions with regard to inputs which, in the view of the United States, are critical. Furthermore, joint machinery for reaching decisions in individual cases would be necessary. Conversely, even a relatively large component of value might undergo substantial change as a result of Canadian manufacturing.

While it does not appear useful to attempt to develop a value-added formula to determine when an original United States component has been sufficiently transformed in Canada to be considered to have taken on a new form, it would be useful to further discuss the whole issue of transformation with United States authorities.

American firms want access to the Canadian markets and may have substantial investments to maintain. Canadian resources are needed in the United States and in some areas Canada has technology of value. Furthermore, the United States is not the only source of the commodities and technology which the United States market currently supplies to Canada under the constraints of their export control policies.

If Canada were to adopt the fourth alternative of simply discontinuing its enforcement of the substance of United States laws on this subject, the

United States authorities could achieve the same results by prohibiting exports from the United States to Canada unless proper assurances against re-export contrary to United States policy have been given. This is essentially the position in which all other countries find themselves vis-à-vis the United States. This would involve additional administrative detail for Canadian importers and United States exporters to Canada, but would permit the Canadian government to withdraw its support of this United States policy and indicate to would-be Canadian exporters that it stands ready to help them expand their exports despite these United States policies. The present posture of the Canadian government probably discourages firms in Canada (whether Canadian or foreign controlled) from soliciting its assistance on this subject, since the government has a clear policy of denying export permits where United States regulations prohibit the trade in question. This change might advance the tendency to search for other sources of supply.

Aside from general policies to increase Canadian capacities to develop a manufacturing sector based on indigenous technology, a review process might play a role in pursuing the fifth alternative by searching out alternative sources of various inputs which have these restrictions attached. It would also take the export limitations into account, if they are significant in the industry involved, in examining a proposed foreign investment or licensing arrangement.

This might, over time, reduce the dependency of Canadian industry on United States inputs and induce a softening of United States rules if the pursuit of opportunities in the Canadian market are foreclosed or made more difficult for United States-based firms. In addition, the experience and information gained through a review process would add to our knowledge about the economic significance of these constraints.

One possible role for a review process could be to seek to expand export opportunities for foreign controlled firms in Canada. The existence of these export restrictions in law would impede its work in this area to some extent—although the significance of the present constraints may not be too great.

ANTITRUST

THE LEGISLATION

The American antitrust legislation specifically seeks to extend the application of its domestic policies against restraint of competition to foreign commerce. The legislation is based on the premise that United States firms must not be denied access to world markets by arbitrary corporate action which restricts competition, nor is the United States domestic market to be denied the benefits of the competitive pressures from any potential sources for imports. Section 1 of the *Sherman Act*, for example, makes illegal "Every contract, combination . . . or conspiracy, in restraint of trade or commerce among the several States, or with foreign nations . . . ."

Through the Sherman and Clayton Acts—the two basic statutes governing conspiracies, agreements and mergers in restraint of trade—the United States has sought to prohibit arrangements that unduly restrict competition either domestically or in respect of United States export and import trade.

Under the authority of these laws, the United States government has asserted jurisdiction over arrangements initiated abroad to restrict competition which allegedly have an adverse impact on the freedom of United States commerce either domestically or in international markets.

Canada has experienced the impact of the extraterritorial extension of American antitrust laws by the United States courts in three basic ways:

(i) The United States courts have asserted direct jurisdiction over persons and firms in Canada, actually having made such persons defendants in antitrust suits.

(ii) The United States courts have attempted to secure evidence which was held in the files of Canadian companies.

(iii) The decrees following a conviction of a Canadian or United States defendant have directed that specific corrective measures be taken in Canada or that the offensive behaviour cease.[41]

The United States courts have asserted jurisdiction over Canadian firms and persons on one of three grounds:

(i) The Canadian firms have on occasion been doing business in the United States subsidiary or through a branch office. (This has led to the actual naming of the firm involved directly as a defendant in the suit.)

(ii) The United States parent, having a Canadian subsidiary under its control, has been seen as a conduit for directing behaviour of the subsidiary, with the United States parent being directed to ensure that certain activities within Canada be altered or discontinued (decrees have affected Canadian firms in this way without their having been named directly as defendants in the suit).

(iii) The existence of a United States parent company with control over a subsidiary abroad has led the United States courts to assert jurisdiction directly over the subsidiary even when the subsidiary was not itself doing business in the United States.

These extraterritorial assertions over foreign business conduct only emerged in the post World War II period. Prior to that time, the United

[41] Decrees requiring positive action are available only under civil proceedings initiated by the public authorities. Prohibitory orders can arise, however, in the context of both public suits and private actions initiated by injured parties. The claimant can recover three times the amount of damages he can establish to result from the offence, so that there is an incentive for such suits to occur. These suits can involve orders which prohibit certain activities occurring outside the United States.

States courts had operated under the assumption that all legislation was *prima facie* intra-national. This reflects, in part, the advance of activity through international business structures and transactions which could readily frustrate the purposes of United States antitrust policy. Blatant circumvention of a domestic policy becomes possible under such circumstances—either through foreign firms set up for that purpose or incidentally used to achieve results not available through domestic action.

The United States courts have paid only limited attention to the policy of the host environment affected by a decree. To date, the United States courts have not found unlawful, or at least have not ordered the cessation (or commission) of, acts which are expressly required (or unlawful) in the foreign jurisdiction involved. This is often achieved through the use of a "savings clause" in the decree. That is, the court accepts jurisdiction, finds a violation and directs that certain acts be committed or prohibited. Where the directives involve activities in a foreign jurisdiction, the court, if shown that the defendant or its foreign affiliate will become liable under legislation of that jurisdiction, by complying with the decree, will insert a provision relieving the defendant from full compliance. The liability under foreign law may not be established clearly in advance, however, and may become apparent only as a result of subsequent judicial interpretation by a foreign court. The United States courts do not acknowledge governmental "permissiveness" or even "encouragement" for the behaviour in question in the foreign location; they desist only when the host government makes something a *requirement*, or *prohibits* the doing of certain acts. While the United States government could conceivably penalize persons in the United States even under such circumstances, the United States courts do not do so of their own accord, and express legislative direction to do so is unlikely—at least on the subject of competition policy.

Historically, the impact of United States antitrust law on Canadian industry has not been serious. There are only a few cases in which the United States decrees affected Canadian activities—and their economic impact has probably been beneficial in terms of increasing Canadian industrial efficiency. Agreements between internationally operating companies not to compete with one another in the Canadian market reduce supply and increase prices. Agreements to divide world markets restrict competition within Canada and limit exports in Canada.

However, United States antitrust laws also influence United States firms in their planning and structuring and this influence extends to their Canadian activities. The United States courts have made businessmen conscious of the fact that their activities outside the United States can limit United States export or import trade, and that such a limitation, in principle, violates the *Sherman Act*.

Incorporating or using an existing foreign subsidiary as a vehicle for participation in an international cartel or restrictive joint venture is a violation of United States law. In theory, the wholly owned foreign subsidiary

could commit an offence if it acts on parental directives involving the restraint of trade, for example a directive involving the division of markets or price fixing. It would appear from the jurisprudence, however, that this causes no problem until the subsidiary acts in concert with other firms. Suppose, for example, that a United States company and a formerly independent company manufacturing a similar product line decide to establish a jointly owned subsidiary in Canada. The Canadian participant, if it had remained independent, would have been free to compete in a manner affecting the import or export trade of the United States (by buying or selling in United States markets). As a result, the undertaking of a "joint venture" could be viewed as a vehicle for limiting competition in United States import or export markets. In such cases, a separate legal entity created under Canadian law offers no protection to the American partner of the joint venture.

From this it would appear that a bias exists in the law for United States firms to establish wholly owned subsidiaries in Canada. Such subsidiaries run fewer risks of being accused of eliminating or limiting exports to Canada in co-operation with a Canadian company or of restricting exports from Canada to the United States of otherwise independent business units. The wholly owned subsidiary would be less likely to be seen as a violation of United States antitrust law—but is not thereby immune from the impact of United States antitrust law if the parent engages in activity which offends that law and the court feels that a remedy will only be effective by directing that certain activities be undertaken by the Canadian subsidiary.

Mergers or agreements in Canada involving a United States participant or subsidiary, even if wholly owned, could be seen as limiting trade with the United States (e.g., the formerly independent Canadian firm might have been selling in the United States market). Similarly, United States firms might have been selling in Canada, and agreements between parent and subsidiary to divide world markets where they formerly both operated could be questioned.

POLICY ALTERNATIVES

The concerns of United States firms about the application of United States antitrust laws to their dealing in Canada could present difficulties for any efforts which might be made to achieve a joint venture, to pursue some form of international rationalization so that the Canadian-based operation of the multinational structure would have export markets allocated to it, or to have product lines developed in Canada—rather than the United States. This latter scheme would have the express purpose of limiting exports from the United States and allocating some of the market opportunities to the Canadian operation. Similarly, any attempts to replace imports of United States components would displace United States exports. Where an agency of the Canadian government is involved and requires such activity—and no independent Canadian interest participates in a way which would suggest a private conspiracy in respect of United States international trade—this would seem to pose

few problems. Joint commercial ventures are less likely to be free of such concerns. In any case, it would be desirable to consider taking whatever steps are reasonably possible to ensure that United States antitrust decrees are not able to frustrate Canadian policy objectives. Canadian policy on competition and on foreign investment could help to fill the void which currently exists in this area. It is the absence of a Canadian policy on this subject which permits United States courts to direct action in Canada.

This shortcoming could be remedied by enactment of domestic competition legislation prohibiting compliance in Canada with certain foreign decrees which were incompatible with Canadian interests. As pointed out previously, Canada's ability to effectively assert its sovereignty in this area is consistent with judicial interpretation in the United States, which has recognized the over-riding authority of foreign jurisdictions where it has been exercised to specifically prohibit or require certain actions. Furthermore, the effective implementation of a Canadian competition policy also requires that account be taken of international business structures and activities. The proposed Competition Act would deal with most of these problems of extra-territorial application of foreign law in a manner which is outlined below.

Before proceeding to discuss possible responses to these problems, it should be noted that international action by governments on these issues—either bilaterally or multilaterally—could go a long way toward reducing offensive extraterritorial applications of national laws and making Canadian policy more effective by preventing harmful business activities which cannot be readily dealt with now by individual jurisdictions. Such attempts as have been made along this line to date, however, have resulted in little of significance, since jurisdictions are jealous of their authority and are not apparently confident that international market forces can be developed to serve their best interests. Some degree of uniformity of policy on the subject of competition would be necessary for effective co-operative action of this nature.

There have been efforts to reach multilateral agreements on competition policy. While offering the prospect of reducing extraterritorial application of law, they also involved attempts by the United States to bring about broader international adoption of its own system of antitrust law. Despite examples of extraterritorial application of United States antitrust law, the United States is frequently frustrated in its attempt to apply its rules against the conduct of American companies doing business abroad. International solutions look most attractive and are simpler than extraterritorial assertions of jurisdiction if the terms of the international rules can reflect sufficiently the substance of the rules of the participating countries seeking to control particular kinds of behaviour. The United States has always found that attempts at international action were inadequate, from its point of view, in that they were based on the continuing supremacy of national laws—most of which were regarded by the United States as not being sufficiently strict. At present, therefore, the prospects for working out a satisfactory international agreement on competition policy are not bright.

There is a long history of unsuccessful attempts at co-operative action dating from 1945, which led to a proposed International Trade Organization at the United Nations in 1948 (initiated by the United States and the United Kingdom). In 1951, an attempt was made in the Economic and Social Council of the United Nations. In 1958, the signatory countries of the General Agreement on Tariffs and Trade (GATT) established an ad hoc consultative procedure, which appears never to have been used. In 1953, an Ad Hoc Group of Experts was created in the Organization for European Economic Co-operation (OEEC), later to become a Committee of the Organization for Economic Co-operation and Development (OECD), which is still at work. While this kind of co-operative international approach being sought by the OECD is undoubtedly highly desirable, the Committee has been able to make little headway to date in obtaining agreement in international procedures to deal with these issues. The United States as included in seventeen or so treaties of friendship, commerce and navigation, a clause which provides for consultation and the taking of "such measures as it deems appropriate with a view to eliminating such harmful effects." Fourteen countries once acted jointly through the OECD to oppose an attempt by the United States Federal Maritime Commission (in 1964) to secure information from shipowners regarding rates on inbound and outbound freight of the United States. By agreement, the governments assisted in presenting limited statistical information, which was not to be used for criminal prosecutions.

Since 1959, an agreement has existed between Canada and the United States—the "Antitrust Notification and Consultation Procedure"—providing that each government "in enforcing its own antitrust or anti-combines laws, consults the other when it appears that the interests of the other country will be affected by such enforcement." This is not a condition precedent to a suit, and does nothing as a matter of law to protect conduct outside the United States which is unlawful under United States legislation. The United States has, however, seemingly modified its approach to the extent of naming foreign participants as co-conspirators rather than as direct defendants and has indicated a willingness to co-operate in some areas of enforcement policy. The legal liability then attaches only to the United States national and the United States relies on the control of the foreign subsidiary to effect behaviour abroad in compliance with a decree.

Unilateral steps have been taken by some governments in response to the extraterritorial application of United States antitrust law. The major focus of legislative reaction against these activities of United States antitrust law has been in the area of documentation. In preparing a case, United States authorities have attempted to secure information on foreign activities, which is often in the hands of foreign firms. The United States has attempted to summon documents from United States-owned pulp and paper subsidiaries. In response, Ontario passed its *Business Records Protection Act* in 1950 prohibiting the removal of corporate records from Ontario where such removal "would be consistent with compliance with any requirement, order,

direction or subpoena of any legislative, administrative or judicial authority in any jurisdiction outside Ontario . . . " In 1958, Quebec passed similar leglslation in its *Business Concerns Records Act*. The United Kingdom has also made provision involving such attempts in the *Shipping Contracts and Commercial Documents Act,* 1964. The most complete statutory opposition would seem to be that of The Netherlands *Economic Competition Act* (S. 39), enacted in 1956. This legislation appears to go beyond information gathering efforts by foreign authorities, in that it prohibits compliance "with any measure or decision taken by any other State, which relates to any regulations of competition, dominant positions or conduct restricting competition." Compliance can only lawfully follow the prior consent of Netherlands authorities. It is not clear as to how much of an impact this legislation would have on the United States courts. Its use has been very limited and appears to have been related to United States attempts at securing information, rather than attempts to apply decrees against conduct in The Netherlands. In fact, Dutch companies have themselves occasionally sought the permission of their government to disclose the information to United States authorities. Instances of granting and refusing such permission have occurred. Such applications which have been granted appear to relate to documentation which was held by the companies in question in their United States offices—permission then being granted for documents held in the United States only.

The two provincial enactments in Canada do not provide for governmental consent and do not prohibit disclosure on a "voluntary" basis by companies within the two jurisdictions. In fact, two Canadian firms were requested by the United States Department of Justice (Antitrust Division) to reply to questionnaires which they sent. This preceded any legal action and was related to assessing the adequacy of the evidence for the instituting of an action. It would appear that the Fulton-Rogers Agreement of 1959 (as is the case with the Basford-Mitchell Agreement of 1969) did not *require* notification of Canadian authorities by either Canadian companies or United States authorities at this stage in the proceedings. (Nevertheless, an *Aide-Memoire* was sent by the United States authorities on April 14, 1964, to inform the Canadian authorities that these questionnaires were to be sent to the two companies.)

The proposed Competition Act would deal with most of the problems related to the effective implementation of Canadian competition policy by providing penalties, prohibitions or orders against persons or firms *in* Canada. The Act would, therefore, not apply extraterritorially, but would seek to restrict the extraterritorial application of foreign antitrust laws to Canada, except with approval of Canadian authorities.

The specific provisions proposed in the Bill are as follows:

(i) Where a decree by a foreign court required implementation in whole or in part by persons in Canada, the Tribunal would be authorized to direct that no measures be taken for such implementation or that only such measures be taken as the Tribunal

prescribes. The Tribunal would prevent implementation in whole or in part of a foreign decree where it adversely affected competition in Canada, adversely affected the efficiency of trade or industry in Canada, adversely affected foreign trade or otherwise restrained or injured trade in Canada. (The Tribunal would prohibit implementation in whole or in part where it found the conduct directed to be inimical to Canadian interests in competition and efficiency.)

Under current judicial policy in the United States, this should suffice to block compliance with United States antitrust decrees when the Canadian authorities decided to prevent its application in Canada. It would also serve to bring Canadian policy to the attention of the United States courts and Administration. While, as noted earlier, the United States could amend its legislation so as to penalize a person within its reach, thereby creating an untenable position for the firm in question, it appears unlikely to do so. Should it occur, the issue becomes one for government-to-government resolution. In fact, while no government is as committed to competition policy as that of the United States, few substantive conflicts would seem likely under the proposed new Canadian competition policy, just as few have arisen in the past. In fact, developing a co-operative effort, which would be able to deal with the implementation of domestic policies that can be too easily frustrated by international business structures, is the more difficult problem. The capacity of the proposed Tribunal to approve the application of foreign decrees would permit Canada to participate in such co-operative efforts, if and when they emerge.

The provision for the blocking of foreign decrees which is embodied in the proposed Competition Act would not, however, prevent voluntary compliance that is not clearly identified as compliance. If, for example, the United States were to order a divestiture of a Canadian firm—or a severance of a relationship between two firms in Canada—the blocking of the decree might not prevent the ultimate sale of shares in the Canadian company unless Canada were prepared to order that this not be done. Such a situation is remote and the likelihood of wanting to block such a divestiture for reasons of competition policy is very slight.

(ii) Agreements between firms outside Canada (e.g., between the parents) which serve as the vehicle for an agreement between the Canadian subsidiaries through the resulting directives from the parent to the subsidiary would be unlawful under the proposed Competition Act where the Canadian subsidiaries were knowingly participating in this vehicle for agreement between themselves and their Canadian competitors. In these circumstances the subsidiaries

would be subject to prohibition against such common action with their competitors.

(iii) Mergers between two foreign firms which place two formerly distinct Canadian firms under common control could give rise to an order from the Tribunal that one of the two be sold if it restricts competition in Canada in violation of the Act. The common parentage would have to be severed—with no impediments to the foreign merger itself being created.

(iv) Similarly, a domestic merger which restricted exports as well as imports would be subject to prohibition where the merger significantly lessened competition in Canada and provided no off-setting advantages. An international merger would be subject to prohibition where it adversely affected competition either by extending an international cartel or international oligopoly into Canada or by restricting exports—in either case without off-setting advantages.

(v) Foreign takeovers which have an adverse impact on domestic competition are also to be covered by the Act.

These steps would permit Canada to have a greater control over the industrial structure and activity of the country and permit the implementation of a policy on competition in Canada which differs in important particulars from that of the United States.

There are some issues which have not been dealt with under the proposed Competition Act. For example, consideration might be given to the desirability of clarifying the role of the Tribunal with regard to prohibiting compliance with a foreign decree so as to include subpoenas or other orders to produce documents. Furthermore, consideration might also be given to requiring permission from some Canadian authority for voluntary compliance with a United States request by United States controlled firms to ensure that it does not frustrate the purpose of the provision. These rules would apply only to the transmission of documents outside the ordinary course of business. A Canadian step in this direction might lead to superior United States-Canadian co-operation on such issues. (Consideration might also be given to extending this rule beyond matters of competition policy so as to cover all foreign information-summoning attempts.)

This provision would make the extraterritorial enforcement of United States laws somewhat more difficult by depriving the enforcement authorities of necessary evidence to prosecute. If, however, the capacity to screen all decrees is effectively applied, a safeguard exists against harmful compliance.

The proposed Competition Act, as with the present *Combines Investigation Act,* permits legal action only against persons or corporations within Canada for agreements which they have entered into affecting competition in Canada. As a result, where the agreement is entered into by foreign parent companies and the subsidiaries in Canada are directed to operate in certain ways—which constitute the acting out of an agreement—no action can be instituted in Canada against these firms. The effects of an agreement

between the several firms in an industry can be achieved without any person or corporation in Canada actually entering into an agreement. By the device of operating in Canada through a separate corporate subsidiary (rather than doing business directly through a branch of the parent corporation), the prohibitions of the proposed Competition Act can be circumvented by companies having international affiliates.

Consideration might be given to holding the Canadian corporation liable for such activities. The Canadian corporation represents the assets in Canada of the foreign conspirator, whose behaviour is in violation of the terms of the proposed Competition Act. While the Canadian subsidiary may be acting pursuant to such an agreement, the Crown may be unable to prove that the officers of the subsidiary actually participated knowingly in the operation of such a conspiracy.

While the approach suggested in this discussion of issues relating to competition policy involves a unilaterial definition of what Canada considers a fair jurisdictional division to resolve conflicts of law, a bilateral or multilateral international approach might prove superior. The provisions in the Competition Act and policy options outlined in this section would not be at all incompatible with such a step and might even hasten the development of such structures or rules. At the same time, such an approach would permit Canada to implement a competition policy which differs in important respects from that in the United States.

SECURITIES

THE LEGISLATION

United States securities legislation is aimed at providing protection for Americans in their investment activities. As a result of the openness of United States and Canadian financial markets, a substantial volume of United States portfolio investments are made in the securities of Canadian companies. Frequently these securities are acquired by Americans through the markets in Canada. On occasion, however, issues of Canadian companies are floated in United States markets to acquire funds for the financing of Canadian corporate ventures. United States securities legislation is concerned with providing protection for United States investors in such circumstances. It is also concerned with preventing Americans from frustrating United States securities policy by using a Canadian corporate framework to raise funds in the United States for a corporate venture south of the border in violation of United States security laws.

United States securities legislation does, however, create situations in which Canadians find themselves directed to comply with American rules—even under circumstances where they do not themselves seek to appeal to United States investors for funds. The most prominent illustration of this problem arose under the provisions of Section 12(g) of the United States *Securities Amendment Act* of 1964. This section imposed upon all stock issuers whose stock traded over the counter in the United States (having

at least $1 million in assets and at least one class of equity securities held by 500 or more shareholders) the obligation of registering, of meeting provisions regarding the soliciting proxies from shareholders, and imposed also a liability under civil law for "short-swing trading" in securities by insiders. The amendment in 1964 extended these obligations to the over-the-counter market from their previous application to stocks listed on United States exchanges.

The decision to trade securities over the counter is not made by the issuer, but rather by the buyers, sellers and brokers seeking to transfer such shares. These legal conditions can thus evolve upon the issuer without his having deliberately sought to make use of United States capital markets or otherwise directly appeal to United States investors. Where the company, its officers and control are all in Canada, the obligations and potential liability under United States legislation have an extraterritorial impact (which may be difficult for the United States authorities to enforce) as the United States seeks to protect United States investors placing their funds through transactions occurring in the United States.

The Canadian government proposed that Canadian companies that deliberately sought direct access to the United States over-the-counter market be subject to the same rules as non-North-American issuers (the Securities and Exchange Commission (SEC) having provided somewhat easier rules for them due to the lower incidence of investment activity in such companies by Americans).[42] The Canadian government also proposed that Canadian companies which did not seek access to the market be given a complete exemption from the rules.

In response, United States authorities made Canadian issuers with stocks on the United States over-the-counter markets subject to the same obligations as all other foreign issuers. The discriminatory feature of the proposed rules was removed. Under the provisions applicable to all foreign companies, registration was not obligatory if the SEC was furnished with certain information. The required information to qualify for the exemption was: (i) that required to be made public by the law of the domicile of the issuer; (ii) that which the issuer filed with any stock exchange on which its securities were traded (if that exchange made the information public); and (iii) that which the issuer voluntarily distributed to its security holders.

These regulations did not, however, relieve Canadian companies from the United States securities rules requiring either registration or information filing, despite involuntary involvement in United States capital markets. One remaining remnant of discriminatory application arose by virtue of the rule 12g3-2(3). It provided that all companies in North America, the stock of which is more than fifty per cent in United States hands and the business of which is administered principally in the United States or by United States directors, were to be subject to the same obligations as United States companies, provided the company has more than 300 shareholders in the United States.

[42] The rules for non-North-American firms permitted the filing of certain information in lieu of registration.

The United States government did not accept Canadian representations to the effect that the application of the rules under 12(g) be limited to Canadian companies deliberately seeking access to the United States market.

The only sanction that has ever been imposed on Canadian firms or seems likely in the near future to be imposed is that of being recorded on the SEC "grey list". This is a list of companies which come within the terms of the *Securities Amendment Act* and the regulations, but which have not registered or gained an exemption from registration by supplying information in lieu of registration. In its background to the adopted rules, the Commisston stated that it expected brokers and dealers to consider the fact that an issuer has been put on the grey list when deciding whether they have a reasonable basis for recommending the issuer's securities to their customers. However, being put on the grey list does not ban trading in the stock. Brokers and dealers are subject to no sanction should they trade in the stock of an issuer on the grey list. Being put on this list, although a very mild sanction, is a sanction none the less. It contains the implication that the company ought to have complied with the *Securities Exchange Act,* and accordingly, amounts to a condemnation of the company for failing to do so. On May 31, 1968, there were seventeen Canadian companies on the grey list, or "foreign restricted list", as it is officially titled.

Aside from this actual sanction, there are several other legally possible sanctions that could be imposed for not registering or providing information in lieu of registration or for other violations of the Act. Under Section 32 of the *Securities Exchange Act* of 1934, any person who wilfully violates any provision of the Act is liable to a fine of $10,000.00 or two years imprisonment, or both. Under Section 21(f) of the Act, the SEC may ask a United States court for a writ of mandamus ordering any person to comply with the Act. If the person refuses to comply with the writ, he is guilty of contempt of court. By Section 20, any company officer or director is punishable for an offence committed by his company. Furthermore, under the common law, a company which fails to perform a legal duty (i.e., to register or to provide information in lieu of registration) can be liable for damages if, as a result of that failure, an individual suffers a loss. A Canadian company could thus be technically liable to a United States investor in an action in the American courts.

If a company does avail itself of the exemption available to foreigners by providing certain information in lieu of registration, the obligations imposed on it are minimal. It need only provide information already made public elsewhere. There is only clerical inconvenience in sending the material to the SEC. However, the SEC is entitled to remove or alter the exemption at any time, and impose on companies filed with it much stricter obligations. Providing information is not so much a problem in itself; the problem arises from the admission of SEC jurisdiction that this co-operation may imply.

Canadian authorities proposed in April 1967 that Canadian companies should not be subject to the SEC jurisdiction, but that, in order to protect

shareholders, both in Canada and the United States, there should be an exchange between governments of all public information about issuers. The Canadian government would give to Americans such information about Canadian firms as Canadian law required to be made public, or which Canadian firms voluntarily made public, and the American government would give to Canadian such information about American firms as United States law required to be made public, or which American firms voluntarily made public. The Canadian government took the position that if the government provided the information, the company would not be submitting to the jurisdiction of SEC. The rules subsequently issued by the SEC exempted a company if the government of the issuer, rather than the issuer himself, provided the necessary information.

The SEC incorporated part of the Canadian proposal in the rules under 12(g). A SEC statement, which extended the information in lieu of registration exemption of 12(g) to Canadian issuers, pointed out that "the continuing improvement in the quality of the information now being made public by foreign issuers, together with the improvement which may reasonably be expected to result from recent changes and current proposals for change in relevant requirements, warrants the provision of an exemption from Section 12(g) (i.e., the information in lieu of registration exemption)".

The outcome of this exchange between the two governments would seem to indicate that an agency in the United States publicly charged with fulfilling a statutory purpose (and subject to Congressional scrutiny) is satisfied if it can achieve its statutory objectives by non-extraterritorial means. But the experience also suggests that a United States agency is not much influenced by the protests against extraterritoriality *per se*. To some extent, the superior level of protection offered nationally in the United States on such matters as securities distribution is at the root of the problem and, the principle of territorial sovereignty aside, the approach adopted by the United States has much to recommend it. It is precisely the policy differences between Canada and some foreign jurisdiction—principally the United States—which creates these conflicts of extraterritoriality. However, it is also on these grounds that the question of which country's public policy is to take dominance is focused. It would presumably be open to the United States to handle this matter by prohibiting dealers from trading in issues which do not meet the SEC standards. Then no extraterritorial effect would exist and only Canadians voluntarily submitting to the jurisdiction of the SEC would be affected by its rules.

A survey as at December 1965, of 23 Canadian firms, revealed that 14 of these firms had met the SEC requirements. These 23 firms had less than ten per cent of their shares outstanding in the United States. Of these fourteen firms, eight had five per cent or less of their total shares outstanding in the United States.

There are further aspects of the extraterritorial impact of United States securities legislation on Canadian companies beyond the "obligation" to register or provide information as an alternative.

An American stockholder in Banff Oil Ltd., a Canadian company listed on the American Stock Exchange, sued Aquitaine of Canada Ltd., Paribas Corporation, a Delaware corporation, and the directors of Banff, alleging that the directors of Banff had sold shares in Banff to the two other companies at the market price which the defendants, who had inside information, knew did not represent the true value of the shares. Banff sold 500,000 shares to Aquitaine at $1.35 a share, and 270,000 shares to Paribas at $7.30 a share. After the sale of these shares Banff announced the discovery of oil on its land. Share prices went up to $18.00. The plaintiff claimed that the vendors and purchasers of the shares knew of the oil discovery before the sale and by selling the shares for less than their worth, reduced the equity of the shareholders. The United States Court of Appeals held that although the sale from Banff to Aquitaine was a sale between Canadians of stock in a Canadian company, the court had jurisdiction in the dispute under rule 10(b)(5) promulgated pursuant to the *Securities Exchange Act*. Rule 10(b)(5) is a broad proscription against fraudulent dealings in securities. It states: "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange, (1) to employ any device, scheme or artifice to defraud, (2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (3) to engage in any practice or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security".

The jurisdictional part of the court's judgment ended with the statement: "We hold that the district court has subject matter jurisdiction over violations of the *Securities Exchange Act* although the transactions which are alleged to violate the Act take place outside the United States, at least when the transactions involve stock registered and listed on a national securities exchange and are detrimental to the interests of American investors."

The case was appealed to the Supreme Court, which, without comment, declined review.

While this case applied rule 10(b)(5) with respect to a company which had listed its shares on an American stock exchange, the court observed that it saw few constraints on accepting jurisdiction over such matters. The decision noted that the SEC "has not promulgated a rule exempting foreign transactions from Rule 10(b)(5)".

POLICY ALTERNATIVES

The requirement of registration or provision of information in lieu of registration in the case of over-the-counter exchanges deals with security transactions taking place within the United States. A condition precedent to such trading is set out under the *Securities Exchange Act*. While this requires Canadian firms to provide certain information, the extraterritoriality involved

is not particularly offensive. The information which is required for filing is that set by public policy in Canada or such additional information as is voluntarily communicated by the company to its shareholders in Canada.

The Canadian government could, if it wished to take unilateral action to resist such extraterritoriality as implied here, unilaterally prohibit Canadian firms from making such information available to authorities. The SEC might then, if it wished to pursue this policy of adequate information for American investors in over-the-counter transactions, prohibit brokers from engaging in transactions of shares on the "grey list". Canadian firms wishing to have their shares freely traded in the United States, however, would be under a serious disadvantage. In addition, not much of substance would be accomplished by this assertion of jurisdiction by the Canadian government. The concern does not appear to lie in cases of listed shares where the company has itself submitted to United States jurisdiction. Concern is expressed where the company has found its shares trading in the United States without any deliberate action on its part. In the final analysis, unilateral action by the Canadian government has significant limitations. The SEC could continue to declare non-compliant Canadian companies in violation of their legislation. The capacity of the SEC to enforce this policy by the execution of its decisions in Canada is, of course, non-existent. In this sense, therefore, there is no direct extraterritoriality involved.

The alternative of an international agreement between Canada and the United States could be considered. It would avoid any extraterritoriality and provide for the exchange of information from government to government, rather than by a requirement of the SEC covering Canadian corporations. Reaching such an agreement would seem to be dependent, however, on development of a Canadian system of security regulation comparable in substance to that of the United States.

It should be borne in mind that there remains in the prevailing United States legislation the provision that a foreign issuer may benefit from the exemption to 12(g) if his government, as opposed to the issuer himself, provides the necessary information to the SEC.

The extraterritoriality involved in the holding of Canadian corporations and individuals liable for violations of other provisions of the United States securities regulations is similarly not readily subject to easy solution by unilateral Canadian action. When American shareholders are affected by actions taking place entirely in Canada, the attempt by the SEC to hold the Canadian corporation or individuals involved liable in damages appears, on its face, to be somewhat more offensive. Nevertheless, so long as these prohibitions and penalties cannot be enforced in Canada (a matter entirely within the jurisdiction of the Canadian government) there is, strictly speaking, no extraterritoriality involved. If American policy finds particular activities to be unlawful, Canadian legislation cannot prevent United States decisions from impeding the Canadian corporations or individuals from ready access to United States capital markets, nor prevent the imposition of penalties on any holdings which these corporations or individuals have in the United States.

UNITED STATES BALANCE OF PAYMENTS PROGRAMME

INTRODUCTION

The United States has experienced balance of payments deficits throughout the past two decades. These deficits initially served a useful purpose in relieving the acute dollar shortage in the rest of the world after the war. But as they continued, the weakening United States dollar became a source of growing concern, and a number of measures have been undertaken by the United States government to deal with the situation. For most of the period, the United States earned a substantial surplus on current account, and the overall deficit arose from the fact that the outflows of private United States capital and United States government expenditures abroad for military purposes and for aid to developing countries exceeded the current account surplus.

The measures taken by the United States to restore the balance were thus primarily directed at reducing the net outflow of capital and easing the foreign exchange cost of the government's overseas aid and military programmes. Although they have produced some results, on the capital side, the problem has become compounded by a decline in the current account surplus itself, so that the overall deficits rose to even higher levels. Accordingly, United States policy has recently placed greater emphasis on measures to restore the trade surplus to its former levels, while maintaining the programme of capital restraints.

HISTORY OF PROGRAMME

The first major action of a restrictive nature taken by the United States was the introduction of the Interest Equalization Tax (IET) in July 1963. Designed to reduce foreign use of United States capital markets, the IET provided for an increase in the cost of raising long-term capital by foreign borrowers in the United States by one per cent. In its original form, the IET was designed as a temporary measure affecting United States purchases of foreign securities of an original maturity of more than three years, including new issues and outstanding issues, and it provided for uniform coverage of the securities of all industrialized nations. It has subsequently been extended both in time and in coverage. In its present form, the legislation gives discretionary power to the President to vary the rate of tax between zero and 1½ per cent. The present rate is ¾ of 1 per cent.

In February 1965 against the background of a rapidly expanding outflow of short- and long-term capital to foreigners, the United States authorities strengthened their restrictions by instituting a voluntary programme to limit the expansion of foreign assets held by United States banks, other financial institutions and corporations. The Department of Commerce took in hand the administration of this programme for business firms, while the Federal Reserve Board instituted guidelines for banks and non-bank financial insti-

tutions. The Department of Commerce requested 600 participating corporations to increase their efforts to expand exports, to limit direct investment in developed countries, to increase the proportion of foreign investment financed through borrowing abroad, and to increase the return flow to the United States of foreign earnings and of short-term assets. The Federal Reserve Board requested banks and non-bank financial institutions to limit the net increase of their foreign credits to five per cent of the amounts outstanding at the end of 1964. These voluntary programmes were continued in 1966 and 1967, with substantial changes each year designed to restrict further the outflow of United States long- and short-term capital.

On January 1, 1968, the control programme took on its present form. The Department of Commerce controls became mandatory and, in their original form, the restrictions on direct investment were very stringent. Dividing countries into major areas, they allowed direct investment (including retained earnings) to exceed the 1965-66 average by up to 10 per cent in the case of developing countries and to equal 65 per cent of the 1965-66 average in the case of Canada, the United Kingdom, Japan, Australia and the oil-producing countries. Subsequently, the United States Administration maintained this provision was not intended to apply to Canada following representations by the Canadian government. For other industrial countries (especially those of continental Western Europe) a moratorium was placed on direct investment outflows. Any expansion would have to be financed entirely by re-investment of earnings. A requirement was also established for the repatriation of earnings, but this provision was later revoked.

The Federal Reserve Board guidelines remained voluntary, but were tightened up. The ceiling on bank credit was reduced to 103 per cent of the base period at the end of 1964 and banks were asked to reduce their outstanding loans to residents of Western Europe. Non-bank financial institutions were asked to reduce their net foreign assets to 95 per cent of the level of 1967, to eliminate their holdings of foreign liquid funds and to refrain from making any new investment in either debt or equity form in Western Europe. Revisions have been made in these programmes in subsequent years, designed in the main to relax the stringency of the direct investment controls and to enable additional credit to be provided to export financing.

IMPACT ON CANADA

The announcement of the Interest Equalization Tax in July 1963 caused immediate and serious problems for Canada. Heavy selling pressure developed against the Canadian dollar. The reserves dropped sharply, causing the government to seek and to obtain an exemption from the IET for United States purchases of new issues of Canadian securities. This principle of exempting Canada was generally maintained throughout the successive elaborations of the United States balance of payments programme up to the

time of the new economic measures announced in August 1971. Canada's current account balance was in large and chronic deficit. A very large current deficit with the United States was only partly covered by the current surplus with other countries and Canada's resulting needs for capital inflows could only be met in the United States. Capital inflows took the form of direct investment and of fixed interest borrowing by provinces, municipalities and corporations in the United States bond market. Since capital imports from the United States were smaller than the current account deficits with the United States, Canada argued that it was not contributing to the United States balance of payments deficit, but rather helping to finance it. Any restriction on Canadian borrowing in the United States could only be offset by adjustments elsewhere in the balance of payments, such as the trade account, which would inevitably affect the United States adversely.

These same arguments were employed in December 1965, to obtain an exemption from the United States voluntary programme when it was extended to cover long-term investment by United States financial institutions and direct investment by United States non-financial corporations. Canada did not initially express great concern over the application of the United States mandatory controls on direct investment in Canada when they were first introduced on January 1, 1968. It was recognized that they were directed against Western Europe, which had been accumulating large balance of payments surpluses. Furthermore, private investment in Canada of all kinds was expected to be lower in 1968 than in 1967 and direct investment from the United States had already fallen in 1967 to about the level that would be permitted in 1968 under the 65 per cent provision. Generally speaking, the advantages of avoiding any limitation on fixed interest borrowing in the United States were regarded as greater than the avoidance of any limitation on direct investment. Moreover, the administrative discretion given to companies in allocating direct investment abroad between various developed countries within the framework of an overall ceiling provided some reassurance that industries, dependent on United States capital, would not suffer unduly. However, a series of developments, including the decline in wheat exports to the Soviet Union and China and the disturbances in the international monetary system at that time contributed to a new crisis for the Canadian dollar early in 1968. A substantial transfer of funds from Canadian subsidiaries to United States parent companies appeared to be taking place, despite a subsequent announcement by the United States government that such massive repatriation of liquid assets was not an objective of the United States programme and that United States subsidiaries in Canada were expected to behave as good corporate citizens. Finally, on March 7, 1968, the United States undertook to exempt Canada from all the United States balance of payments measures affecting capital flows that were administered by the Department of Commerce or the Federal Reserve System.

In return for the exemptions from the IET and the Commerce and Federal Reserve Board programmes, Canada gave certain undertakings which

were designed to assure the United States that undue use would not be made of the exemptions by Canada, and that they would not lead to an evasion of the restrictions affecting other countries by a movement of funds through Canada. At the time the original exemption from the IET was obtained in 1963, Canada undertook to ensure that funds would not be borrowed in the United States in order to add to the official reserves of gold and foreign exchange. This implied a ceiling on the reserves of around $2,700 million, the level which had been reached prior to the announcement of the IET, and this ceiling was maintained with some downward revision until December 17, 1968. In an exchange of letters of that date between the Minister of Finance and the Secretary of the United States Treasury, this ceiling was replaced by a more general understanding that it was not in Canada's interest to increase its reserves through unnecessary borrowing in the United States market. This recognized the fact that the IET had proved to be more long lasting than had originally been anticipated and that the expanding capital markets of other countries provided Canada with a means of achieving an increase in its reserves which would not be at the expense of the United States.

Secondly, Canada issued a series of guidelines for Canadian banks on May 3, 1968, non-bank financial institutions on July 24, 1968, and non-financial corporations on September 19, 1968, to ensure that unlimited access to the United States capital market by Canada would not result in by-passing the United States balance of payments guidelines. These guidelines, which are voluntary in nature, did not aim to reduce Canadian foreign holdings, but they did seek to maintain them at their then current levels. As such, Canadian subsidiaries were not restricted from re-investing funds earned abroad. Individual Canadians could also invest in third countries, the only restriction being that they should not purchase "offshore" United States corporate bonds.

Canadian banks were asked not to increase their foreign currency claims on residents of countries other than Canada and the United States above the level held at the end of February 1968, unless this increase was accompanied by an equal increase in total foreign currency liabilities to residents of third countries. Non-bank financial institutions were asked to limit the increase in their foreign currency claims on residents of third countries to the level at the end of June 1968, unless the increase wholly represented liabilities to residents of third countries, or arose out of net earnings of foreign branches or subsidiaries. Non-financial corporations were requested not to increase their holdings of assets in continental western Europe in any way that involved a transfer of capital from the United States or Canada. Restraint was to be exercised in any investment in other countries and should in the first instance be of a nature that would improve Canada's trade and international payments position.

Thirdly, Canada agreed to invest the United States dollar portion of the official reserves in excess of working balances in special non-marketable

United States Treasury securities. This served the purpose of reducing the United States balance of payments deficit on the liquidity basis, but it did not affect the deficit on the official settlement basis.

CONCLUSIONS

To the extent that the United States programme prior to August 1971 applied to outflows of capital from the United States, it did not involve extra-territorial application of that country's policy. On the other hand, in trying to influence the dividend policy and the import and export activity of United States controlled firms abroad, it was serving to transmit United States government policy to other countries through the network of parents and subsidiaries. That portion of the programme aimed at influencing the behaviour of United States controlled firms abroad did, therefore, contain a measure of extraterritoriality.

Canada was largely exempted from the United States programme at its request up to the time the new measures were adopted in the summer of 1971. In return for these past exemptions, Canada took certain steps which were of assistance to the United States.

The need to seek an exemption from the United States reflected the dependence of Canada on the United States for capital, reflected by the current account deficit in the Canadian balance of payments. It also reflected some of the gaps in the Canadian capital markets.

In reaching these arrangements, a certain cost has been incurred by Canada. Its financial firms have been limited by the restrictions on capital exports. Much more importantly, during the period of the ceiling on exchange reserves and the maintenance of a fixed exchange rate the choices available to the monetary authorities in regulating credit conditions were reduced. In particular, the level of interest rates had to take account of the need to minimize capital inflows. While the inflows could, up to a point, be offset by Canadian government purchases of non-marketable United States securities when excess exchange reserves were being accumulated, this did not constitute an entirely satisfactory response. Thus, the exchange reserve limitation involved some restriction on the use of monetary policy as an instrument to fight inflation.

With the elimination of the current account deficit, the balance of payments need for Canada's exemptions from the United States programmes is no longer as great. The exemptions are still of some value, however, largely because certain provincial governments may not be able to obtain all of the funds they need in the Canadian market.

During most of the 1960's, the Canadian exemption from the United States programme reflected both the current account deficit and the inability of the Canadian capital market to mobilize the sums needed for some large borrowings and equity issues. If the United States programme had applied to Canada, it might in theory have been possible to apply exchange controls

in order to prevent an acceleration of dividend payments or excessive business service charges from Canadian subsidiaries to their parents and more generally, to maintain the level of the exchange rate. But the problem of satisfying Canada's need for investment capital in the domestic capital market alone would have remained, at least initially. Accordingly, it was difficult for Canada not to seek the exemptions.

So long as Canada's current account position remains in surplus or moves into only a moderate deficit, any future United States balance of payments programme which applied to this country would conceivably be more tolerable from the viewpoint of Canada's balance of payments. Canada would, however, continue to require some foreign direct investment for reasons unrelated to its balance of payments position. In addition to other factors, such investment might be required when Canadian capital markets were incapable of mobilizing domestic savings for a particular undertaking—perhaps because of its sheer magnitude, an aversion to undertaking the specific risk involved or deficiencies in the market itself. Thus, to develop a capacity to resist any future extensions of United States balance of payments policy to Canada there is a primary need to obtain better entrepreneurship in Canadian capital markets.

Chapter Seventeen

THE IMPACT OF FOREIGN CONTROL OF CANADIAN BUSINESS ON CANADIAN CULTURE AND SOCIETY

INTRODUCTION

This chapter examines the impact of the high degree of foreign control of Canadian business on Canadian culture and society. It begins with a consideration of cultural attitudes in Canada which have facilitated foreign direct investment. It goes on to consider the impact of foreign direct investment on the cultural and social environment. It concludes that there is a high degree of interaction between the above two factors. At the same time, however, the presence of large volumes of foreign investment concentrated in United States hands increases the difficulty of developing a distinctive Canadian culture. This has potentially serious implications because the economic and political strength of a country lie largely in the creation of a cultural, social and political milieu which favours indigenous initiative and innovation.

In assessing the impact of very heavy foreign and, in particular, United States corporate investment on Canadian culture, it must be frankly admitted that this is a subject on which views are bound to vary widely. Means are not available for simple quantitative assessments, and any qualitative efforts to make an "objective" evaluation are bound to reflect the arbitrariness of the ideological and sociological assumptions of such a study.

Before proceeding further, it is important to clarify the term "culture". Culture is not simply the arts, architecture, films, books, sculpture and paintings of a nation. Culture is the historically developed values and patterns of behaviour covering the whole range of human activity. Quite simply, the culture of a people is its entire way of life. Culture is reflected in the role of private property, the political and legal system, patterns of family life, sports, aspirations for growth and higher standards of living, the social distribution of wealth, the role of the market-place, the role of government, business and other interest groups and the relationship between them, the relations between labour and management, to mention but a few of the facets of culture.

It has been argued that Canadians should not worry about the concentrated United States ownership of Canadian business, but about maintain-

ing the cultural integrity of the broadcasting system and making sure that Canada has an active, independent theatre, book publishing industry, newspapers, magazines, and schools of poets and painters. If this is meant to deny the foreign corporation acts as a transmission belt for cultural influences, it reflects a rather naive view of culture and nationhood. There is no way of leaving the "economic" area to others so that we can get on with the political, social and cultural concerns in our own way. There is no such compartmentalization in the real world. When understood in this broad sense, there can be little doubt that economic activity, as organized in the modern corporation, has a profound impact on culture, especially on the nature of the social, political and economic system, and the technology employed.

Given the complex inter-relationships within a culture, it is difficult to isolate and analyse the corporate impact, whether domestic or foreign, on culture. This is especially true in the case of Canada, since it is basically an open society and many influences have shaped Canadian culture and society. It is difficult, for example, to distinguish those aspects of our cultural and social development which are the effects of general industrial, technological and economic development and those which are foreign importations. It is equally difficult to disentangle the influence of foreign control of Canadian business from the impact of a common language, the mass media, political tradition similar in numerous respects, the use of the same books at universities and at public schools, imports, travel, common professional associations and trade unions, and close family and friendship links. Of course, there is a feedback process involved and inter-corporate links between Canada and the United States reinforce some of these other relationships. In any event, it will always be difficult to determine whether a particular aspect of United States influence in Canada is related to corporate control or other types of cultural inter-relationships.

CULTURE AND FOREIGN DIRECT INVESTMENT: CANADIAN OPENNESS

In Chapter Three of this study, the determinants of corporate direct foreign investment were discussed. In the manufacturing area, it was suggested that one or more of the following determinants were important:

—basic efficiencies or economies of scale;
—technological, marketing, or some other superiority;
—market power based on product differentiation in an oligopolistic industry, including the ability to create tastes;
—similar tastes;
—high per capita real income;
—a rapid rate of growth in real income;
—factor endowments;
—size of market;
—competitive climate;

—tariff and non-tariff barriers;
—transportation costs;
—proximity to source of investment (as a risk-reducing factor);
—adequacy of infrastructure and supporting service.

It is useful to look at the cultural impact of foreign investment in terms of these determinants. Some, of course, are the result of the "openness" of Canadian culture referred to above, but to some extent foreign direct investment appears to create or foster cultural similarity. Let us look at some of these determinants in greater detail.

Countries of similar cultures and per capita real income appear to be particularly susceptible to direct investment. There are some important differences between Canadian and United States culture; the two official languages and multicultural character of Canada; the republican form of government in the United States; the acceptance in Canada of a greater role for governmental action, such as that in the field of broadcasting and transportation; distinctive Canadian institutions such as the Caisses Populaires in Quebec, and the greater importance of socialist parties in Canada. Nevertheless, there are numerous and important cultural similarities and these facilitate direct investment from the United States.

A further factor which has facilitated foreign direct investment is that Canadians, by and large, are not very xenophobic. Furthermore, Canadians generally claim fewer national heroes and distinctive symbols than most other countries. Many Canadians seem to have less pride in their history and in their achievements. While British, American or French history is, in a certain sense, part of our own history, it is often taught more assiduously than Canadian history. The reasons for this are very complex, but in part Canadian diffidence towards nationhood appears to arise out of Canada's colonial past. In more recent times, Canada's proximity to the dynamic and powerful United States has induced some feeling of dependence or inferiority.

The lack of a strong national identity tends to create, as outlined above, a vacuum and a greater receptivity to foreign influence and investment. The ease of importing our culture from the United Kingdom or the United States reinforces this tendency by reducing the pressure on Canadians to develop their own cultural distinctiveness. In these circumstances, foreign investment has had substantial opportunity to shape and influence the Canadian environment. Looked at from the point of view of the United States investor, the openness and lack of cultural distinctiveness reduce the risk and cost of foreign investment since there is less need to adapt the product locally. Thus, foreign investment at one and the same time plays on cultural similarities and reduces the capacity for the distinctive development of national identity.

It is interesting to consider the situation of Quebec in the light of this analysis. Quebec has a distinctive culture, largely the result of a different language, different religious and educational institutions and different historical roots. French Canadians in Quebec are, by and large, taught the history of French Canada. They know their heroes and their symbols. Numerous

policies are aimed at retaining and developing this culture, particularly those relating to language and education. These differences may make Quebec less likely to draw foreign direct investment from some sources than Ontario—because of cultural differences. It is, of course, very difficult to determine whether the higher rate of United States investment in Ontario is the result of cultural similarity or an economic and industrial environment more attractive to foreign investment.

THE IMPACT OF FOREIGN DIRECT INVESTMENT ON CULTURE

In discussing the determinants of foreign direct investment in manufacturing, it was suggested that direct investment arises from the desire of a manufacturer to exploit in foreign markets some distinctive capacity developed by him, probably for his domestic market. This distinctive advantage (whether it be technology, a differentiated product, marketing, financial or management skills) has been developed in a particular cultural milieu and embodies certain cultural values. These may be good or bad, but they exist. Foreign direct investment is often accompanied by the cultural outlook and attitude of the country from which it comes. In the case of the United States, direct investment brings with it a belief in the free enterprise system, a system that evolved originally in Britain but came to be embraced with greatest fervour south of the border. Some of the precepts and values which have accompanied foreign investment, particularly that from the United States, include the following:

—individual responsibility;
—equalization of opportunity;
—social and geographic mobility;
—ideological opposition to state intervention (except for protection from "unfair" competition);
—use of the employer-employee relationship (e.g., collective bargaining) rather than general legislation to achieve certain social goals;
—skill training;
—growth and expansion of output;
—exploitation of resources as soon as discovered;
—technological advance;
—planned obsolescence;
—product innovation and differentiation;
—increased consumption through mass marketing techniques, including want creation and "hard-sell" advertising if necessary; emphasis on packaging and branding.

This is not to suggest such precepts and values would not have developed in the absence of such investment.

Some of the less desirable aspects often attributed to United States corporations should, in the opinion of some, be attributed largely to the impact of modern technology. However, as pointed out above, it is for all practical purposes impossible to distinguish the impact of these two forces because they are almost always associated with each other. Be that as it may, technology tends to be a great leveller. It has little interest in preserving distinctive national cultures. Quite the reverse; it tends to erode national cultures. Technology is based on the value of efficiency and efficiency tends to minimize and obscure cultural differences, for significant differences require local adaptations and raise costs. This is not to say that efficiency is the only value embodied in technology. Technology is developed in a particular milieu and tends to reflect certain other cultural values. For example, technology developed in the United States seems to place greater emphasis on rapid innovation and change and the satisfaction of peripheral wants, which are more often deliberately created in the United States than appears to be the case in Europe. This seems to be especially true in manufacturing sectors dominated by United States multinational companies. Compare the engineering and design and the rate of change in these two factors of a Chevrolet on the one hand and a Volkswagen or Volvo on the other.

This is not to say that Canada should opt out of technological society, but rather that if technology is developed for a foreign market it is likely that the use and adaptation of this technology to meet local cultural demands will be minimized. If technology is in Canadian hands (e.g., indigenously developed or even imported through licence rather than at the initiative of the foreign direct investor), the chances are greater that its use will be adapted to the needs of the Canadian milieu.

Another important characteristic of the foreign investor, particularly if he is an MNE is his marketing power. This marketing power may be based in part on economic factors, such as superior technology or marketing skills, but it may also be based on non-economic factors such as product differentiation, packaging and branding.

The large investments required in the creation of new technologies and new products means that corporations must assure markets for them by spending vast amounts on advertising to create the wants and formulate the tastes, in the absence of which financial disaster could result.

The product is thrust upon the consumer in all media. This marketing approach is particularly effective in Canada because of Canada's close proximity to the United States, the cultural similarity, and the existence of advertising spill-over. A "product image" often exists in Canada even before a dollar is spent on advertising here.

Since a significant number of foreign controlled companies operating in Canada lack some of the decision-making powers and activities of a normal Canadian controlled business enterprise, their activities can be described as "truncated". Some of the decision-making powers normally reserved to the parent relate to business expansion—including the decision

to produce a new line, the raising of equity and other forms of long-term debt, research and development—including product innovation, and all the planning and organizational functions of the multinational enterprise. In some instances other decisions, such as those relating to the procurement of goods and services and exporting, are also taken by the parent. Truncation, of course, affects more than the scope for decision-making in foreign controlled companies. The activities associated with these strategic types of decisions may also be concentrated in the parent organization. The degree of truncation in each case will vary with the nature of the industry, the personality and strength of Canadian management, the corporate philosophy of the parent, and the position of the Canadian subsidiary in the company's global organization.

The exercise of vital entrepreneurial functions by the parent, with the consequent truncation of entrepreneurial activities in the Canadian subsidiary, has adverse effects not only on Canadian economic development, but also on Canadian society in general. Truncation means less challenging jobs for the Canadian techno-structure, which must frequently look to the United States for more challenging job opportunities. If you want to be on the ninety-fifth floor, with global horizons, you must go to New York; the highest one can go in Canada is the fifty-fourth floor. But the effects of truncation go beyond reducing the number of challenging jobs for the relatively small group of Canadian entrepreneurs and managers. The under-development of the Canadian techno-structure has adverse social and cultural effects in that the "spill-over" benefits resulting from the interaction of these "brains" takes place not in Canada, but abroad. Truncation also tends to engender a mentality of the second best, with horizons and vision constantly centred on headquarters abroad. It represents a continuation of the colonial mentality described above. This attitude is manifested in many ways, such as the preference for finishing a youth's education by sending him or her to Oxford, Harvard, the London School of Economics or the Sorbonne, rather than in Canada. It is manifested in the difficulty of recruiting top quality foreigners for business or our universities because of the general view that the best opportunities exist not in Canada, but abroad, where parent companies and other centres of decision are located. The general effects of truncation are vividly summed up in the phrase "branch plant mentality".

The ease with which foreign capital can be imported via portfolio and direct investment, and technology and entrepreneurship via direct investment (and the combined result of all of these assets imported through trade) has diminished the pressures for Canada to develop these most creative aspects of business to their fullest extent among Canadians. Canadian society and culture have suffered as a result. However, the effects of truncation are not the only operative forces in this situation. The fact that Canadian society has tended, particularly in the past, to be dominated by an establishment based more on social connections than ability and providing only limited scope for social mobility has contributed to the failure of Canada to develop

entrepreneurs at the same rate as the United States. Social rigidity has induced the expectation and mentality of working for others.

Truncation also influences education and the relationship between Canadian society and Canadian universities. There tends to be a correlation between the type of education and training which is developed in universities and the types of job opportunities available. In Canada, the universities and business schools will tend to prepare people for work in a "truncated" economy. As a result, an important dimension is probably missing from our educational system. To the extent that the educational system does produce creative individuals who want to be "top dog", these people have difficulties in finding the type of employment they want in Canada's truncated companies.

The United States manager who often accompanies United States direct investment in Canada also has a considerable cultural impact as a member of the business community. Having been born, educated and raised in the United States, being familiar with the history, geography, and culture of that country, his impact is bound to reflect social and cultural values mounted in an American milieu. Often he brings with him a taste and preference for United States products and ways of doing things which go beyond the methods of doing business. His membership in American-based professional associations and clubs, his family and friendship links with the United States, for example, will tend to reduce his identification with the Canadian community.

The propensity of foreign controlled companies to source a greater portion of their purchases of goods and services in the country of the parent company has been discussed in Chapter Eleven. This tendency means that a foreign controlled company acts as continuous transmission belt and that the cultural impact is greater than simply the impact of the initial investment.

The cultural impact of foreign investment is magnified to some degree by the sectoral distribution of this investment. There is high foreign control in industries which have considerable cultural impact such as book publishing, and in industries which are responsible for the dissemination of culture, such as film and book distribution. Foreign control, and United States control in particular, is high in those industries in which taste formation, product innovation and differentiation are crucial, such as automobiles, pharmaceuticals, and electrical appliance products. High foreign investment in the resource industries has less of an impact on culture because the purpose of the investment is basically extraction and export, and the resource industries employ—and thus affect—relatively fewer Canadians.

It is interesting to speculate whether the cultural impact of foreign corporate activity (including the possibility of creating a more distinctive Canadian culture) might be decreased if foreign investment were not so heavily concentrated in United States hands.

Might not the introduction of a greater diversity of sources of investment enhance the prospect of developing a distinctive Canadian identity? Such a policy of diversification would be consistent with the concept of a review

process which advocates the search for better alternatives. On the other hand, there can be no assurance that a change in the mix of foreign direct investment would make a significant difference to the basic cultural similarities that have facilitated the large inflows of foreign direct investment, particularly from the United States.

CONCLUSIONS

The penetration of Canada by foreign direct investment, particularly from the United States, has been facilitated both by the lack of a strong sense of Canadian national identity and by the cultural similarities between Canada and the United States.

Control of a substantial portion of Canadian business activity by United States corporations is likely, in turn, to have had a significant impact on the Canadian cultural environment. There is a "continuous feedback" relationship between foreign direct investment and Canadian culture, with cultural similarities facilitating foreign direct investment and foreign direct investment, in turn, inducing greater cultural similarities.

To maintain that United States direct investment has had a significant cultural impact on Canada, it is not necessary to make a precise judgment about the exact impact of United States investment, nor to draw up a balance sheet of what is good and bad in the cultural impact of the United States corporation. Some effects have probably been beneficial. The introduction of greater cultural variety and choice no doubt enriches Canadian life. On the other hand, the extension of United States methods of marketing and promotion have had some undesirable effects. It can be asserted with some degree of confidence that the presence of large volumes of foreign investment concentrated in United States hands increases the difficulty of developing a distinctive Canadian culture. This has potentially serious implication since the economic and political strength of a country lies largely in the creation of a cultural, social and political milieu which favours indigenous initiative and innovation.

Canadians appear to be concerned about the development of a distinctive Canadian culture in the face of high and growing levels of foreign investment in Canada. The question arises whether a policy that restricts foreign investment has a role to play in achieving this objective. Unless such restrictions were very severe, and thus highly protectionist, it is doubtful that they would have a major impact on Canada's cultural development. The impact of a moderate policy would probably only be marginal; it would not be a substitute for the development of specific cultural policies to foster the development of a stronger Canadian identity, as advocated by the Royal Commission on National Development in the Arts, Letters and Sciences.

Socio-cultural attitudes in Canada are evolving; in particular a new and more confident sense of nationhood seems to be developing. A foreign investment policy could be regarded as one useful manifestation of this new nationhood.

Chapter Eighteen

THE IMPACT OF FOREIGN CONTROL ON THE POLITICAL PROCESS AND PUBLIC POLICY

INTRODUCTION

The purpose of this chapter is to assess the impact of the high degree of foreign control on the Canadian political process and the content of Canadian public policy.

One of the major difficulties in undertaking such an assessment is isolating the impact of the foreign controlled firms from the generally widespread impact of American influence in Canada that makes itself felt through a variety of other channels. On the one hand, much of the United States influence in Canada is due to factors other than United States investment. On the other hand, the investment does contribute to the general openness between the two countries, both by itself and by encouraging the continuing flow of trade, persons and ideas across the border. This point has been dealt with in Chapter Seventeen. It is reiterated here only to underline the difficulty of undertaking a definitive analysis.

In examining the impact of foreign control upon the political process and public policy, two factors must be considered.

One is the political behaviour of the foreign controlled firm, which could cover such actions as its intervention in an election to support or oppose a particular political party or candidate, its appearance before a parliamentary committee to support or to oppose a policy, or, more subtly, its promotion of an image which it may find helpful in its dealings with government. It is, therefore, necessary to consider the conscious inputs of these firms into the policy process.

The second factor requiring consideration is the impact the foreign controlled firm has on the outputs or decisions of the political system and on Canada's political options. The fact that a foreign controlled firm may put great pressure on a government certainly does not mean that the government will knuckle under to it. Conversely, the fact that a foreign controlled firm may not intervene consciously and actively in the political process does not mean that the decision of the government may not be affected by the fact that the firm is foreign controlled or that the choice facing the govern-

ment may not be influenced by the overall degree of foreign control in the economy.

Until the past decade, successive federal governments were inclined to view the country of corporate control as a matter of indifference in most cases. In adopting this attitude, earlier governments probably did not anticipate that this would result in such extensive foreign control of Canadian business as has, in fact, emerged. Even if they had anticipated such a development, however, they might have been prepared to accept it in view of their desire to attract manufacturing activity to Canada and to encourage resource exploitation.

Whatever the rationale, it seems clear that the extensive and concentrated foreign control which exists today, although it may have helped in the achievement of certain objectives, has also shaped and limited the present choices available in Canada in some spheres of policy. It has also had some bearing on Canada's ability to achieve other national objectives. Moreover, extensive foreign control may involve even greater constraints on the options open to Canada in the future.

The discussion below is in two main parts. The first considers the conscious *behaviour* of the foreign controlled firms. The second focuses on the political *impact* of the foreign controlled enterprises on political choice and public policy. Such an approach conforms to developments in the study of the political system over the last decade or so. Traditionally, the Canadian political system was defined by political scientists largely in legal and institutional terms. Standard textbooks outlined the role of the legislature, the executive, the judiciary, the relationship of the three branches to one another, the structure of federal-provincial relations, with a briefer account of parties, elections and pressure groups. While the result was a reasonably good description of the institutions and their formal relationships to one another, it tended to be somewhat static and rigid.

More recently, students of the political system have concentrated more on government as a dynamic process, with the political system being viewed as a more open universe. The relationship between individuals and organizations in the society and the authoritative political decision-makers is developed and elaborated through the "input-output" approach—at its very simplest the inputs consist of the varying influences on the political system and the outputs taking the form of the decisions ultimately adopted by the policy-making body.

THE BEHAVIOUR OF FOREIGN CONTROLLED FIRMS (INPUTS)

Conceptually, it is possible to envisage a very wide range of methods through which foreign controlled firms might seek to influence the political system and policies of a host country. To list every conceivable technique would be a difficult task and of little value. But it is useful to illustrate the

wide spectrum of possibilities so as to place in perspective the political behaviour of foreign controlled firms in Canada. Six different degrees of possible intervention are considered below. The extent to which each is experienced in Canada is a question for consideration.

(i) A foreign controlled firm could conceivably act on its own or as the political agent of its home government in an effort to overthrow or to maintain in power the host government to help advance its own policy objectives or those of its home government. Conversely, the foreign controlled business may solicit the support of its home government to overthrow or maintain the régime in the host country. At its most extreme, these possibilities may involve revolution or coup d'état.

While such intervention is clearly illegitimate, the practice is not unknown in the modern world. For instance, some international resource companies have on occasion tried and succeeded in helping to overthrow or to prop up régimes in other parts of the world.

However, there is no evidence to indicate that foreign controlled firms have ever sought the non-constitutional overthrow of the Canadian governmental system by acting on their own, by soliciting the support of home governments, or as a result of being enlisted by their home governments.

(ii) A less extreme version of the above would involve very active intervention of foreign controlled firms in Canadian general elections, either at the behest of their home government or on their own initiative. It seems generally to be accepted that business firms, like other individuals or groups in society, do have the right to contribute to a party's election funds, or provide other forms of assistance. But it is doubtful this would be the case if intervention were carried to an extreme: for instance, if a foreign firm with large financial resources were to give a massive sum of money to one party in an election campaign.

With respect to elections, the formal organizations of the business community do not generally give open collective support to any one political party. Thus, while particular firms or businessmen may publicly support a political party, or contribute to one or more parties, such organizations as the Canadian Manufacturers' Association, the Canadian Chamber of Commerce, the Canadian Textiles Institute and the Canadian Chemical Producers' Association do not normally do so. In other words, foreign controlled firms obviously do not cloak their intervention in electoral politics by having the trade associations act on their behalf.

Secondly, no evidence is available that would suggest that the behaviour of the individual foreign controlled firm differs in any

significant way from that of the domestically controlled business firm in election campaigns.

(iii) Another way in which the foreign controlled firm might influence the political process would be by responding to the directives or requests of its home government to influence host government public policy. In practice, while there might be isolated illustrations of such behaviour, there is no evidence of this being a common activity.

(iv) A fourth method by which the foreign controlled firm could influence the political process is though its capacity to obtain the support of its home government to uphold its interests in Canada. In general, the right of a home government to make these kinds of representations to the government of a country in which one of its firms has established a subsidiary is accepted as legitimate.

Experience up to the present has not revealed much intervention by foreign governments—which can, of course, vary considerably in degree—to protect the interests of corporations based on their countries. In part this might be because there is little discrimination between foreign and Canadian controlled firms in Canadian law and public administration. And, of course, when a foreign government does seek to intervene on behalf of a subsidiary, it does not necessarily follow that it will be able to convince the host government to modify its position. The cases of the Mercantile Bank and Time-Reader's Digest are the two most obvious examples of foreign government intervening in the political decision-making process in support of their investors in Canada. Thus far, in respect of the divestiture rulings of the Canadian Radio-Television Commission, there has been no substantial intervention by the United States authorities, possibly because the United States has broadcasting legislation not unlike Canada's. In summary, only a few problems have arisen as a result of foreign controlled firms drawing their home governments into the Canadian political process.

(v) Less direct, but perhaps no less important, is the part played by foreign controlled firms in shaping and influencing the advice which various levels of government receive from the business community. Foreign controlled business firms play active roles in such trade associations as the Canadian Manufacturers' Association and the Canadian Chamber of Commerce. Indeed, they probably provide a substantial source of financial support for the CMA. Foreign controlled firms are also active in various formal and informal government advisory committees, such as the National Advisory Committee on Petroleum and the Business Advisory Committee reporting to the Minister of Industry, Trade and Commerce. Moreover, the attitudes and outlooks of foreign controlled firms can

influence the thinking of Canadian controlled enterprises, many of which do business with them on a large scale.

Western political philosophy accepts the premise that individuals and groups have a legitimate right to try to influence public policy and to secure redress from grievances by lawful collective action. Indeed, much public policy emerges out of the clash of conflicting group interests. It is further recognized in the democratic political system that the business community, no less than other organized groups, is a participant in the political process and that this is entirely proper, subject to appropriate traditional and legal limitations.

These facts take on a particular significance when viewed in the Canadian context. Many of the largest and most concentrated Canadian industries are dominated by foreign controllled firms and inevitably the policies and attitudes of these firms reflect those of their parent companies. Some of the political pressures which are brought to bear upon the Canadian government come from *within* the Canadian political system through the medium of subsidiary firms and can reflect the interests of foreign businesses.

These facts do not, of course, constitute an indictment of the behaviour of foreign controlled firms. For one thing, the subsidiary doubtless sometimes expresses itself to the Canadian government in much the same way as it would if it were Canadian controlled, in that the parent firm frequently does not have an interest significantly different than that of a Canadian controlled business. Secondly, the subsidiary is a Canadian entity under Canadian law, and thus entitled to the right of making representations to the government. Indeed, it is recognized that good corporate citizenship is by no means restricted to Canadian controlled firms, nor bad citizenship to foreign controlled enterprises. Thirdly, the government normally has a continuing need for information from business. If the firms in a sector which is largely dominated by foreign controlled enterprises were unwilling to come to Ottawa and to talk, information that was required might not be available to the government. This, of course, by no means pre-supposes that the information or advice from business is accepted uncritically.

Thus, it is not a criticism of the individual foreign controlled firm to observe that it can at times serve as a vehicle for foreign corporate influence within the Canadian political system. However, there are around 9,000 such firms in Canada, around 6,000 are United States controlled and many of these are among Canada's largest firms. The cumulative impact of their normal political activities, therefore, gives the United States corporate view a very important voice in the Canadian political arena. Accordingly, the views

expressed by Canadian industry will be heavily influenced by United States business interests.

The illustrations below are intended simply to indicate the ways in which the behaviour of foreign controlled firms is likely to be different than Canadian controlled firms. These differences reflect the logic of being a multinational enterprise.[43] A multinational firm cannot, at any point, be maximizing the output and profitability of each sub-unit. It is concerned with developing the kind of global strategy which will maximize overall objectives. Furthermore, those establishing the overall objectives are more remote from the Canadian environment and Canadian influence than is the case for Canadian controlled firms.

For instance, it seems clear that the advice the government has been receiving from leading producers in Canada with regard to rationalization of the structure of the rubber tire and chemical industries reflects very strongly the fact that they are not controlled from within Canada and hence not prepared to contemplate rationalizing in ways which might be possible if they were indigenous firms. The sceptical view expressed by some members of the petroleum industry about the need for a vertically integrated Canadian controlled petroleum firm similarly seems attributable in part to the fact that most of the firms are not Canadian controlled. These kinds of illustrations in part reflect only the fact that these various industry associations advising government act first and foremost from self-interest. This is not surprising. Most interest groups are, of course, motivated by self-interest. The point is that the substance of their advice reflects the fact that these firms do not always have the same interests as a Canadian controlled firm. The central decision- makers at headquarters are subject to pressures from several countries. They are also more remote from Canadian government influence and bound to reflect these facts in their decisions.

To take another example, the very strong representations made in respect of proposals for changes in taxation of mining firms reflected the international scope of the industry and the fact that most of the firms in it were foreign controlled multinational enterprises. Thus they were able to warn, with some credibility, that they would shift resources to other countries in the event that the tax burdens put upon them were too great. To a substantial degree, this was also true of the Canadian-based multinational mining companies. Or to take a different kind of case, the likelihood of securing the support of the telecommunications carriers in the Telesat project might have been much more difficult had these firms been foreign controlled.

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[43] The same points are true, by and large, for the foreign controlled firm which is not a multinational.

Thus, on issues of industrial and related aspects of economic policy, the political inputs and environment are influenced by foreign control and the structure of the multinational enterprise. This can, of course, have an impact that spills over in other areas, such as cultural objectives—as in the case of Telesat, which will play an important role in bringing broadcasting and improved communications to the North. On other aspects of public policy more generally, however, the impact of intensive foreign control is less evident. Certainly foreign controlled firms seem not to intervene politically on issues of social, cultural and foreign policy. Their political behaviour in these issues is not noticeably different than the behaviour of Canadian controlled firms.

(vi) Finally, and more generally, political behaviour in Canada can be influenced by the impact of the foreign controlled firm on the Canadian political culture. That is, Canadian political behaviour may through time absorb and reflect the political values of the home countries of the non-resident controlled firms in Canada. In this instance, because of the dominant position of United States controlled firms, it is the United States political culture which is being referred to. As this point was examined in Chapter Seventeen, no further comments are needed here.

THE IMPACT OF FOREIGN CONTROLLED FIRMS ON PUBLIC POLICY

Two questions requiring consideration are whether the influence of foreign controlled firms on public policy differs significantly from that of Canadian controlled firms and what impact extensive foreign control has on Canada's political choices and options. As the political behaviour of foreign controlled firms was examined above, it will be evident that these analyses do not simply assume that the impact of foreign controlled firms is related directly to their behaviour. For one thing, the effort of any firm to influence policy is by no means always successful and, therefore, it need not be assumed that wherever the foreign controlled firm intervenes in the political process, it is able to affect policy. By the same token, policy can be influenced by the existence of foreign connections, even when the foreign controlled firm does not consciously intervene at all. These points are elaborated on below.

The first point which must be noted, even if evident, is that foreign controlled firms have not had a direct influence on the structure of the Canadian political system or on the choice of Canadian governments. This view is entirely consistent with the conclusion above that foreign controlled firms seem not to intervene actively in such matters.

There is limited evidence of public policy being altered due to the intervention of foreign governments in Canadian affairs to protect the investments of their nationals.

Foreign controlled firms can affect the content of Canadian public policy even without consciously aiming to do so. For instance, the government recognizes that certain kinds of policy alternatives are more or less impracticable because of the structure of certain industries and the fact that some of the firms in it are not controlled in Canada. At the same time, additional possibilities are opened up. For instance, possible new developments in public policy in respect of the rubber tire, industrial chemical and oil industries are all at one stage or other of consideration. A problem in each case is how the government can help rationalize, make more efficient or otherwise get greater benefits from these industries. In each instance, the number and nature of policy options open to Canada are influenced heavily by the international structure of the firms concerned and the fact that they do not have the freedom to rationalize in the way which they could if the firm were Canadian controlled. On the other hand, international rationalization within the firm is feasible in some cases. Similar considerations apply in the case of Canadian controlled multinationals, although they are not normally as powerful and the firms concerned are at least a little more sensitive to the Canadian environment.

The reason why firms behave differently are set out earlier.[44] The significance of this difference clearly has an important bearing on certain aspects of public policy. As already suggested, the choices confronting Canada in industrial policy obviously are influenced by the size, structure and importance of the foreign controlled sector in Canada. Commercial and competition policy must similarly reckon with the high degree of foreign control. Even balance of payments and monetary policy are influenced by foreign direct investment and the international openness to which it contributes so heavily.

Other aspects of public policy are less influenced by foreign control, although foreign policy, which is considered in the following chapter, is certainly affected. If social and cultural policy are influenced, this is by and large less directly through the cultural impact discussed in Chapter Seventeen.

The capacity of the government to implement policy can also be affected by foreign control. For instance, in coping with the Canadian balance of payments crisis at the beginning of 1968, the government's task was made more difficult by the United States announcement that foreign controlled firms would be subject to the United States balance of payments programme. Similarly, one aim of the government's foreign policy is to diversify Canada's external ties and this can be frustrated by the close trade, technological and personal links which accompany heavy United States investment. The extraterritorial application of United States trade and antitrust legislation also serves to impede the realization of Canadian industrial and trade objectives, including, to a certain degree, rationalization of domestic industry.

The fact that foreign control can hamper the implementation of policy has been recognized by the government. The fact that no new foreign controlled banks can be chartered in Canada apparently reflects the belief of

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[44] See opening of this chapter.

the government, in part, that it might be more difficult to implement monetary policy through foreign controlled banks in Canada or possibly that such banks would have a greater capacity to resist requests by the Bank of Canada. Even where moral suasion is not at issue, the government has already in the past taken the view that foreign control can matter in certain circumstances, such as in the legislation not to allow foreign controlled firms to hold broadcasting licences. The implication of this decision is that the objectives of the *Broadcasting Act* cannot be achieved solely by Canadian content regulations; that to achieve the fullest implementation of Parliament's objectives, control must reside in the hands of Canadian citizens. These kinds of considerations provide some noneconomic reasons for designating a sector as a "key sector". This point is dealt with more fully in Part Six.

In summary, foreign control does not seem to have had a direct bearing upon the Canadian political system or on the selection of Canadian governments.

It has, however, had some influence on both the content and implementation of public policy. There have been one or two cases of foreign government intervention to support the interests of their investors in Canada, which have affected the content of public policy. What is more important, however, is the fact that industrial policy and some other aspects of economic policy are heavily influenced by extensive foreign control. The logic of the multinational enterprise imposes constraints on Canada in these areas which would not otherwise exist; it also opens a few options which would not otherwise occur. These constraints and options spill over into commercial policy and radiate outward to influence other aspects of economic policy. In other areas of government policy (e.g., federal-provincial relations, social policy), any impact which foreign controlled firms might have is much less direct.

Foreign control can also make more difficult the task of implementing policy, though this is by no means a major problem in most situations. In occasional cases it may preclude the achievement of objectives. More often, however, it simply complicates the task of policy enforcement or necessitates the use of more complex methods than would otherwise be employed.

Chapter Nineteen

THE IMPACT OF FOREIGN CONTROL ON THE FORMATION AND CONDUCT OF CANADIAN FOREIGN POLICY AND RELATIONS

INTRODUCTION

The preceding two chapters have dealt with the impact of foreign control on culture, and on the political process and public policy generally. This chapter looks more closely at the impact of foreign control on one particular aspect of Canadian public policy, namely, the formation of foreign policy and the conduct of foreign relations.

For the purposes of this section, the "formation" of foreign policy is taken to include both the broad posture that Canada has adopted in the world and the more specific policy objectives which are set from time to time as part of this posture to best serve various Canadian interests. These are the issues considered in the first half of this chapter.

The "conduct" of foreign relations is concerned with how Canada seeks to implement these objectives and the constraints on our doing so, with particular reference to the United States. This is dealt with in the second half of the chapter.

At the outset, it must be recognized that the impact of foreign control on the formation and conduct of foreign policy is not simply a result of the behaviour of individual foreign controlled firms. Certainly there is little evidence that foreign controlled firms set out consciously to influence the government with respect to general foreign policy, to persuade it, for example, to adopt a policy reflecting the views of the company owners or in tune with the national goals of the firm's home country. Nevertheless, the impact of foreign controlled firms on both the formation and conduct of foreign policy can still be quite substantial because of the way they indirectly affect certain foreign economic policy objectives, and more generally, due to their influence on the Canadian culture.

FORMATION OF FOREIGN POLICY

CULTURE AND FOREIGN POLICY FORMATION

The formation and conduct of Canadian foreign policy are dependent in the first instance on the way in which national identify and interests are perceived. This perception grows out of the cultural environment (encom-

passing the political, economic and social facets of the nation), which is conditioned by a variety of factors—including foreign influences. Among these influences, that of the United States dominates. The United States influence in Canada clearly consists of more than United States direct investment in Canada. Nonetheless, United States investment has been one influential factor in shaping the general environment within Canada—the environment within which national identity and interests have been perceived and articulated and, more particularly, in which foreign policy has been formed.

For many years after World War II, policy formation in Canada occurred within the framework of close international cooperation between western states which had grown up during that war and the adjustment period immediately thereafter. During those years, in a domestic situation of generally rapid economic development, foreign direct investment was widely considered to be an important benefit. Moreover, the perception of a distinctive Canadian identity and interests during that period was not as evident as it is today.

More recently, some questions have been raised about these attitudes and policies, questions arising in part from concern with the volume and concentration of foreign direct investment and also to some extent from a fresh way of perceiving and articulating the values and interests broadly common to the 22 million Canadians. The White Paper on Foreign Policy dealt with these developments by focusing on the desirability of diversifying Canada's external relationships. The government's aim is to strengthen Canadian external relationships with all areas, rather than to concentrate on an exclusively continental orientation.

There was little observable change in the pattern of foreign direct investment through that part of the 1960's for which statistical data are available.[45] United States investment accounted for 80 per cent of direct investment. It seems likely that foreign direct investment is likely to continue to come heavily from that country.

This, in turn, means that Canadian culture is likely to continue to be influenced heavily by the large amount of United States direct investment in Canada, which must inevitably have some influence on the formation of Canada's general posture toward the world.

As for the more specific aspects of foreign policy, they are examined under the two rather arbitrary subsections below on "political" and "economic" policies.

FOREIGN CONTROL AND FOREIGN POLICY FORMATION—POLITICAL

Apart from the indirect but significant United States influence suggested above, there is little to indicate that the foreign policy options actually considered by the government have been limited directly by the degree of United States business control in this country. Canada, for example, maintained

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[45] See Chapter Two.

diplomatic relations with Cuba when other western hemisphere countries broke them. The Canadian decision not to negotiate until recently for recognition of China took into account a variety of factors, among which United States investment in Canada played no noticeable part. Of course, the major foreign policy differences between the United States and Canada during the past ten or fifteen years over such issues as Cuba, China and Vietnam, have not been consciously exploited and the same view as that taken by Canada has often, in fact, been supported within the United States by important groups.

It is not clear how the United States (or other western governments) would react if Canada were to strike out on a radically different foreign policy line, recognizing East Germany, North Korea or North Vietnam for example. But any reaction is not likely to be motivated in Washington primarily by the volume of United States direct investment in Canada, but by a number of other considerations, mainly geo-political in nature. It might, however, also result in a much tougher line on the various economic "special arrangements" entered into over the years with Canada.

In summary, the direct influence of foreign business control on the formation of specific foreign "political" policies has been marginal at best.

FOREIGN INVESTMENT AND FOREIGN POLICY FORMATION—ECONOMIC

Foreign economic policy is taken to include Canadian commercial and financial policies. Aspects of financial policy have been dealt with earlier in this study[46] and are, therefore, not considered again here.

As for trade, Canadian policy since World War II has hinged largely on the desirability of a gradual multilateral reduction of barriers to trade. This has, by and large, been achieved through successive multilateral trade negotiations under the auspices of the General Agreement on Tariffs and Trade (GATT). Since the Kennedy Round, efforts have been proceeding in GATT for further negotiations. Although preparatory work is nearly complete, there has been a lack of will to move to the negotiating stage for several reasons. One is the resurgence of protectionism in the United States and elsewhere. A second is the tendency toward regionalization of the world into two or three large trading blocs, centered around the European Economic Community, the United States and Japan. These trends carry with them the risk of major trade confrontations between the blocs.

Foreign investment seems to influence the formation of trade policy in three ways. Firstly, it may influence trade patterns because of the propensity for intra-affiliate trade to grow by comparison with trade at arm's length. In this case, it seems to reinforce the already strong trend toward North-South trade. If foreign direct investment in Canada were more diversified, trade patterns probably would also be more diversified. Firm conclusions on this subject are difficult to draw, however, in view of the complex relationship between trade and investment.[47]

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[46] See Chapter Sixteen.

[47] See Chapter Three.

Secondly, foreign control has an influence on the freedom of subsidiaries to purchase goods and services and to export.[48] In the past, these restrictions seem not to have been recognized sufficiently in the formation of trade strategy.

Finally, of course, careful attention is given to the representations of domestic industry in forming trade strategy. Many of the firms are subsidiaries. Their views are either based on the position of their parent—or are at least consistent with it. Thus, indirectly, Canadian strategy can be influenced by interests of the parent firms of the subsidiary. In this case, it again means a heavy United States influence, a fact which may not be lost on our other trading partners.

POLICY ON TRADE WITH COMMUNIST COUNTRIES

As this has been considered at length in the chapter on Extraterritoriality,[49] it need simply be repeated here that policy toward Communist countries can be affected by the influence of United States legislation and regulations on Canadian subsidiaries of United States firms. The converse of this situation is that since Canada recognized the Peoples' Republic of China, representatives of that country have declared that they do not wish to do business with United States subsidiaries.

CONCLUSIONS

Foreign direct investment, particularly from the United States, has had some impact on the broad foreign policy posture and the general formation of foreign policy and relations, through its effect on the cultural environment in Canada. The impact on specific "political" policy objectives, however, does not appear to have been great.

United States direct investment in Canada, and the associated development of increasingly close trade and other links with the United States, have been important factors in fostering development by Canada of a policy of multilateral trade as a counterweight to trade links with the United States. Efforts to develop such a policy tend to be offset, however, by the traditional strength and growing size of our trade and investment ties with the United States. It is further endangered by the threat to the international trade system posed by emerging trade blocs and rising protectionism.

Foreign control—especially heavy United States control—may affect trade relations, e.g., by restricting the freedom of subsidiaries to export and import freely, including trade with Communist countries, and by its general influence on trade strategy.

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[48] See Chapter Ten and Chapter Eleven.
[49] See Chapter Sixteen.

CONDUCT OF FOREIGN RELATIONS

The impact of foreign business control on the conduct of Canadian foreign relations is both direct and indirect. Direct influence is felt generally in the handling by the government of relations with other countries and, more specifically, in the implementation of foreign economic policy. The high degree of foreign direct investment also has an indirect impact through the part it plays in shaping the image of Canada abroad and the views that others have of this country. This image could affect the position other countries adopt toward Canada in negotiations and accordingly the Canadian capacity to realize policy objectives.

CONDUCT OF RELATIONS WITH THE UNITED STATES

How does foreign control influence the conduct of relations with the United States? In a general sense, it is obvious that foreign control increases the links and complicates what would in any event be the most complex of Canada's foreign relations. In addition, foreign control has facilitated—and in some cases made necessary—the various special economic arrangements between Canada and the United States, especially in respect of vehicles, defence production sharing, balance of payments and oil. Each of these is touched on briefly below.

The point in common in each case is that foreign control (to one degree or another) has prompted or facilitated the special arrangements. In turn, the arrangements have caused Canada to become more closely integrated with the United States, narrowing Canada's economic and political options.

In general, the Automotive Agreement has brought important economic benefits to Canada. However, at the same time there appears to be a diminished capacity for the Canadian government to influence further the behaviour of this industry without additional action of a legislative or regulatory nature.

It seems clear from discussions with the industry that if the Government wishes the industry in Canada to meet certain goals, e.g., in regard to production or investment, the Government would need to set them itself. But at the same time, the industry is undoubtedly aware that the United States government may have the power to counteract such steps by putting pressure on parent firms or by threatening to end the Agreement. In other words, domestic control of the automobile sector remains limited, although this disadvantage appears to be outweighed by the benefits of the Agreement.

As the automotive subsidiaries cannot be expected to act automatically in a way consistent with Canada's interests, continued direct intervention by the Canadian government may have to be considered. This could raise an additional issue in Canada-United States relations.

It is difficult to see how this kind of problem can be avoided in an area as important as the automotive industry, with the degree of foreign control that exists in that industry.

The Defence Production Sharing Arrangement was entered into following cancellation of the Avro Arrow. At the time, the Canadian government decided that while Canada might not be able to maintain an independent military equipment capacity, it wished to ensure that the Canadian industrial economy benefitted from defence contracts and that the Canadian balance of payments did not suffer unduly from large purchases abroad of defence material. The arrangement envisages a rough balance of expenditures each country makes in the other. In fact, Canada has had a positive balance on defence equipment account with the United States and has developed a highly specialized defence-related industrial capacity.

At the same time, the degree of United States ownership and control has increased noticeably, with United States interests buying into an increasingly rationalized industry. United States influence is exercised also through licensing and other arrangements.

The United States control of the Canadian defence industry has made it difficult to develop similar defence production arrangements with other countries, notably the French and Germans, either because licensing agreements between Canadian and United States firms contain restrictions which prevent the Canadians from using the licensed technology or weapons in arrangements with third countries, or because the third countries believe this to be the case. One impact has thus been to bind Canada more closely into the North American economic and defence framework.

It seems possible that the corporate links between oil companies in Canada and those in the United States have facilitated the access of Canadian oil to the United States market (as has the security of overland supply), an access which has traditionally been on better terms than accorded even to other western hemisphere suppliers. These corporate links tend, however, to create additional difficulties in our relations with the United States.

While the Interest Equalization Tax and the Federal Reserve Guidelines—two of the elements in the United States balance of payments programme—are not related in any direct way to foreign direct investment, the United States Department of Commerce Guidelines are directed explicitly at United States direct investment abroad. As such, these Guidelines represent another link in Canada's economic relationship with the United States. The concern that the Department of Commerce provisions would apply in Canada, due to the high level of United States direct investment in this country, reinforced the need for Canadian exemptions. This exemption has been yet another factor bringing Canada into an even closer relationship with the United States.

Three questions are at issue: whether the existence of corporate links provides levers to the United States government—in addition to the many already offered by the extensive inter-relationship between the two countries—with which to bring pressure to bear on Canada; whether these levers are used by the United States; and how the existence of these levers affects the conduct of relations on issues unrelated to direct investment. (There is a

further question, not explored here, whether these corporate links also provide some leverage to Canadian authorities.)

The answer to the first question is obviously in the affirmative. Direct investment provides additional handles which the United States could use to put pressure on Canada over unrelated issues.

At the same time, the weight of evidence suggests that there has been little overt tendency on the part of the United States to use pressure in one area to gain advantage in another. On occasion, however, the tactic appears to have been resorted to.

In general, both countries have tended to take a pragmatic approach to bilateral problems. There is a constituency in each country with an interest in any given issue, be it primarily a question of foreign ownership, agriculture or other trade matter. These constituencies usually prefer to see the two governments deal with each issue in isolation and strike a balance in that area (a balance which normally turns out to be regarded as positive for each, though perhaps not equal). Thus, the conduct of relations is not especially influenced by direct investment considerations, apart from those special arrangements discussed above.

CONDUCT OF RELATIONS WITH COUNTRIES OTHER THAN THE UNITED STATES

The close relationship between the economies of Canada and the United States has not been lost on European countries or Japan. The degree of United States control of Canadian business and the policy affinities which exist between the two countries may have on occasion prejudiced the Canadian position in relations with third countries, including our ability to achieve foreign and commercial policy objectives.

In many areas, Canada is in effect lumped with the United States by other countries during international discussions and negotiations as having or presenting the same problems (if any) as the United States. In this way, actual and distinct Canadian problems, aims or differences of view can be overlooked. Thus there was a tendency among Europeans and others to equate the Canadian and United States viewpoints during the pre-negotiating stage and negotiations proper in the Kennedy Round. More recently, in the context of negotiations for enlargement of the membership of the European Economic Community, members of the EEC tended to deny that Canada had separate interests which need to be recognized. In exploratory discussions with both France and Germany on cooperative defence production arrangements, both were reluctant to become involved with firms in Canada on a shared production basis due to the links or special arrangements with United States firms.

In the eyes of some Communist or neutral countries, the extensive United States control of Canadian business may tend to make Canada appear a "servant of United States capitalism" and thus undermine Canada's cred-

ibility as a nation with independent policies. This, in turn, could perhaps frustrate Canadian objectives in specific areas of foreign policy.

The countries of Western Europe and Japan have for historical and other reasons become accustomed to owning domestically the great bulk of their own enterprises. There seems little doubt that they find it hard to understand the nature of the Canada-United States relationship and the fact that we have allowed such a considerable amount of United States business control. They have tended to conclude that Canada is, in fact, already fully tied in with the United States.

CONCLUSIONS

From the preceding discussion of the conduct of foreign relations, it emerges that foreign direct investment has little impact on the general handling of day to day relations with most countries, with the possible exception of the United States. However, in economic areas such as trade negotiations, the conduct of Canadian foreign relations has been considerably affected by the existence in Canada of a large degree of foreign control of business. These corporate links have contributed to situations in which Canada has sought special arrangements with the United States which have had the effect of increasing the economic and other ties between the two countries.

The extent and concentration of foreign direct investment in Canada has affected the image of Canada abroad as an independent country pursuing policies based on its own clear and distinct requirements and interests. Both south of the border and in third countries Canada has tended to be closely identified with the United States. This has at times weakened the Canadian negotiating position *vis-à-vis* both third countries and the United States.

Within the framework of industrial development policy, it may be desirable to consider the further evolution of policies that emphasize Canadian strengths and search for ways to develop them through new kinds of arrangements with Europe and the Pacific countries. This would be a concrete way of helping to achieve the government's aim of diversifying Canada's external relationships.

It would also seem desirable to give consideration to the manner in which Canada's economic relations with the United States are conducted, and particularly whether the establishment of a relationship that is more at arm's length would be possible and more in the Canadian interest in some circumstances.

It appears from the analysis in this study that there is a correlation between American investment in Canadian business and the movement of goods and services between affiliated firms. Direct investment thus strengthens tendencies to continental integration and is a constraint on Canada's future freedom of action. Moreover, this continuing process of integration proceeds without the Canadian government and people having taken a conscious decision to move in that direction.

At a time when emerging world trade blocs pose the risk of Canada being left outside a large regional group unless it negotiates a continental

relationship with the United States it would seem important to consider the significance of these developments for basic Canadian foreign economic policy options. If Canada wishes to limit continentalism, it may be necessary to consider some controls on foreign direct investment, since corporate ownership links, once established, accelerate continentalism through the large volume of trade and the movements of personnel which they help generate.

Even if there should at some point be a decision in favour of greater continentalism, some government control of foreign direct investment might be desirable. In the event of the creation of a Canada-United States free trade area, for example, it is possible that United States firms which are not now well placed in the Canadian market would seek to obtain a part of the Canadian market as rapidly as possible in an effort to beat out their United States competitors. The quickest way to do this, in most circumstances, would be by acquiring a Canadian firm with well-developed market channels and with established production capacity, rather than establishing a new firm. The United States firm concerned would then likely rationalize on a North-South basis. In view of the much greater size of the United States market in virtually all such cases, and the fact that the headquarters of the parent are in the United States, most or all the functions normally carried out at or near headquarters—such as planning, financing, and research and development—would be consolidated in the United States. Canadian capacity for innovation would then be badly damaged.

The reverse possibility, that Canadian firms would buy United States firms to gain quicker access to the United States, is plausible. In reality, however, few Canadian firms have the financial resources to move in a large way into the United States market through an extensive program of acquisition, whereas many United States firms have the financial capability of moving into the Canadian market in this way.

There is also the danger that production could be moved out of Canada in this kind of a continental arrangement, though the risk of losing productive capacity may not be quite as great as the risk of losing innovative capacity. Many firms prefer to produce in the larger market, either owing to the arbitrary preferences of the owners or because it is easier to sell from a United States base. Even if Canadian production costs are lower, investors (including those from third countries) may prefer to locate their large North American plants in the United States lest the Canadian-United States arrangement come to an end and they find themselves outside the tariffs and other import restrictions applying to the very much larger United States market. Some administrative capacity to safeguard Canadian production to avoid this danger would therefore seem to be highly desirable, although it should be borne in mind that such administrative intervention is not a substitute for policies aimed at giving Canada lower production costs.

Chapter Twenty

HOW GOVERNMENTS HAVE RESPONDED TO FOREIGN DIRECT INVESTMENT

CANADIAN POLICY TOWARD FOREIGN DIRECT INVESTMENT

INTRODUCTION

Traditionally, Canadians have had growth aspirations which have normally exceeded the available human and non-human resources in the country, leading governments to seek to attract these resources from abroad.

These aspirations were reflected in past immigration policies, under which Canada sought to fill various kinds of gaps through the import of people to provide a particular skill or to populate a particular region. Similarly, Canadian tariff policy in earlier years sought to attract manufacturing activity. Various kinds of federal and provincial governmental incentives were offered to encourage resource exploitation by Canadian and foreign interests alike. There was a deliberate effort to make Canada a hospitable place for foreigners to invest. In recent years, a number of provincial governments have at times been prepared to go to considerable lengths to attract foreign investment to their province.

Within this generally very open framework, certain measures have been taken through the years which have had the effect—directly or indirectly—of either limiting direct investment in certain areas of the economy or of imposing conditions on its entry.

Heavy public investment in certain parts of the transportation, communications, atomic energy and hydro-electric industries ensured that there would always be an important Canadian presence in those parts of the economy. For instance, federal ownership of Canadian National, Air Cannada and the Canadian Broadcasting Corporation has had the effect of limiting the scope for substantial non-resident control in those sectors. Similarly, provincial ownership of hydro-electric utilities and of some telephone companies has reduced the possibilities for foreign direct investment in those areas.

A second way in which foreign investment has been partially controlled has been through public regulation of certain sectors of the economy. Although

public regulation in various fields, such as transportation and energy, has not been directed particularly at foreign controlled firms, it has had the effect of helping to ensure that the foreign controlled firms behaved in a way consistent with Canadian policy objectives.

Public policy has responded in three other ways: through certain restrictions on foreign investment; through measures to increase the benefits and reduce the costs of foreign investment; through efforts to encourage Canadian ownership. Each of these three approaches is considered further below.

RESTRICTIONS ON FOREIGN DIRECT INVESTMENT

Since the mid-1950's, legislation has been enacted restricting or prohibiting foreign investment in what were regarded as "key sectors" of the Canadian economy.

Financial Institutions

In the mid-1950's, six Canadian life insurance companies were acquired by non-resident controlled firms. As a consequence, certain amendments to the Canadian and British Insurance Companies Act were adopted in 1957. One provided that a majority of the board of directors must be Canadian citizens resident in Canada. A second granted to the directors the power to refuse to allow the transfer of shares from a resident to a non-resident. The third provided a procedure whereby a company could buy its own shares for the purpose of converting itself into a mutual company. Five companies immediately took advantage of this, four of which were very large.

Following the publication of the Report of the Porter Royal Commission on Banking and Finance in 1964, consideration was given to banking and other federal legislation concerning financial institutions. Following the 1957 insurance legislation, two other large, federally registered insurance companies were taken over by United States interests and the acquisition of another was imminent. To block further acquisitions of life insurance firms, amendments were enacted in 1964-65 that placed a limit on the proportion of shares that could be transferred to non-residents. This limit was placed at 25 per cent, or the existing proportion owned by non-residents where it was already higher than 25 per cent. It was also provided that share transfers could not be made to any one non-resident if this would increase his shareholding above ten per cent. No provisions were enacted that placed any limitation on the acquisition of shares of life insurance companies by residents.

At the same time, similar provisions were introduced in respect of federally incorporated trust and loan companies. In all three industries, the provisions on share ownership did not apply to the establishment of new firms.

The amendments to the *Bank Act,* adopted in 1967, contained the same restrictions on transfer of shares to non-residents as had been included in the *Canadian and British Insurance Companies Act* in 1964-65. But they also contained an additional provision putting a maximum of ten percent on

the proportion of the shares that could be owned by any shareholder, resident or non-resident. The restriction holding aggregate non-resident ownership to 25 per cent was also applied to new banks. Under the *Bank Act,* the growth in the total liabilities of banks which have foreign ownership in excess of the prescribed statutory limits is regulated by the Governor-in-Council.

In addition to the restrictions on share transfer to non-residents outlined above, the various laws provided for a minimum of Canadian directors. The *Bank Act,* the *Loan Companies Act* and the *Trust Companies Act* provided that at least three-quarters of company directors should be Canadian citizens, resident in Canada. In the case of life insurance firms, the provision was that a majority had to be Canadian citizens, ordinarily resident in Canada.

In 1971, the *Investment Companies Act* was passed. It prevented further foreign acquisitions of federally incorporated sales financed firms.

It is important to note the difference between the legislation affecting banks and the legislation affecting other federally incorporated financial institutions. Both prevent foreign acquisition of Canadian controlled firms. However, there is nothing in the non-banking legislation which would prevent foreigners from starting up new firms in these areas, whereas the *Bank Act* does not allow foreigners to start up a new bank. Furthermore, as banking is exclusively subject to federal jurisdiction, there is no way in which foreigners can extend their control of the Canadian banking system through provincial incorporation. The possibility of provincial incorporation in respect of the other financial institutions makes the federal initiative in those industries a less certain instrument for preserving an important Canadian voice in these industries. The fact that the Ontario, Manitoba and Alberta Legislatures have enacted legislation in respect of loan and trust companies similar to the federal legislation, however, closes a part of the gap.

Ownership Restrictions: Cultural Activities

Canadian ownership and control of broadcasting has been an objective of governments for about forty years. For much of that period this objective was implemented chiefly by the Canadian Broadcasting Corporation. Following the Report of the Fowler Commission, Parliament adopted the *Broadcasting Act* of 1958, which set a limit of 25 per cent on foreign ownership of any broadcasting undertaking—excluding cable television. The Act also permitted exemption of existing undertakings from the foreign ownership limit by Order in Council. By regulation issued under the *Radio Act,* cable television was placed on the same basis in 1964.

The new *Broadcasting Act* of 1968 placed conventional broadcasting (broadcasting transmitting undertakings) and cable television (broadcasting receiving undertakings) under the Canadian Radio-Television Commission. The Act required that the Canadian broadcasting system should be effectively owned and controlled by Canadians in order to "safeguard, enrich and strengthen the cultural, political, social and economic fabric of Canada". By

a Direction issued under the Act, the Governor-in-Council instructed the Commission that licences could not be issued or renewals granted except to Canadian citizens and eligible Canadian corporations, as defined in the Direction. There was no provision for exemption, except through recommendation by the Commission to the Governor-in-Council, and the existing foreign owners of Canadian broadcasting undertakings were required to divest their interests to come within the new legal limit of twenty per cent.

An eligible Canadian corporation was defined as a corporation incorporated under the laws of Canada or a province. The chairman and each of the directors must be Canadian citizens, and at least four-fifths of the voting shares and shares representing in aggregate at least four-fifths of the paid-up capital must be beneficially owned by Canadian citizens or Canadian corporations. The Direction also provided that if a corporation met the foregoing conditions, but in the opinion of the Commission was nevertheless effectively controlled from outside the country, the Commission should not issue a licence to that corporation. Divestiture of foreign interests to conform to the Direction is now nearing completion.

It has been recognized that the social, political and cultural objectives expressed in the *Broadcasting Act* cannot be achieved solely by ownership regulations or directions. Regulations respecting Canadian programme content have, therefore, been strengthened and are gradually being implemented by the Commission.

As for magazines and periodicals, this has been an issue of controversy since the early 1950's, when the Canadian publications of *Time* and *Reader's Digest* were already playing an important role in Canada and imports such as *Better Living* were also enjoying widespread circulation.

In March, 1956, a twenty per cent tax was imposed on gross advertising revenue of any magazine which contained at least 25 per cent of the editorial content of its home edition, and which carried some advertising not found in the home editions specifically directed at the Canadian market. This apparently had the effect of heading off plans by *Newsweek* and *Business Week* to establish Canadian editions. After the change of government in 1957 this tax was withdrawn.

In December 1961, the O'Leary Commission recommended the prohibition of foreign published business papers containing advertisements directed to the Canadian market and the prohibition of other foreign publications which had Canadian regional edition or "split runs" directed at Canada. It also recommended that advertising in foreign periodicals directed at Canadian markets no longer be deductible for income tax purposes.

In 1965, amendments to the *Income Tax Act* and the *Customs Act* were introduced which had the practical effect of preventing the establishment of new foreign controlled newspapers and periodicals and the foreign takeover of existing newspapers and periodicals under Canadian control. The amendment to the *Income Tax Act* provided that, in computing taxable income, no

deduction could be made for the cost of advertising directed primarily at the Canadian market in an issue of a non-Canadian newspaper or periodical dated after December 31, 1965. Exemptions were, in effect, made for the foreign controlled magazines or newspapers then operating in Canada, which had the effect of exempting *Time* and *Reader's Digest*. The Custom Tariff change had the effect of prohibiting entry of non-Canadian periodicals containing advertisements directed at the Canadian market.

Ownership Restrictions: Canadian Participation Provisions (CPP)

The CPP were first introduced in 1960 as a part of the Canada Oil and Gas Land Regulations and the Canada Mining Regulations, pursuant to the *Territorial Lands Act* and the *Public Lands Grants Act*. They apply to oil and gas leases in the Yukon, the Northwest Territories and offshore and to mining leases in the Northwest Territories and offshore.

Oil and gas and mining leases, under the CPP are granted only to persons who are Canadian citizens over 21 years of age and to Canadian corporations in which the Minister responsible is satisfied that:

(a) at least fifty per cent of the issued shares are beneficially owned by persons who are Canadian citizens, or

(b) the shares are listed on a recognized Canadian stock exchange and that Canadians will have an opportunity of participating in the financing and ownership of the corporation, or

(c) the shares are wholly owned by a corporation that meets the qualifications outlined in (a) and (b) above.

In practice, these requirements do not constitute a major restriction on foreign control. They have done little to increase Canadian ownership and control of oil, gas and mining in the territories subject to federal jurisdiction.

Other Restrictions on Foreign Control in Specific Industries

In recent years, the government has acted to limit, to one degree or another, foreign control of Canadian satellite telecommunications and Canadian uranium property. In the case of Telesat Canada, provision has been made that ownership will be divided between the federal government and its agents, approved telecommunications common carriers and other Canadian citizens. Not more than twenty per cent of the outstanding common shares of Telesat that are held by persons other than the federal government or its agents, or by approved telecommunications common carriers, may be owned by non-residents. Directors must be Canadian citizens, normally resident in Canada.

In the case of uranium, government announcements have indicated that restrictions are to be imposed which will limit foreign ownership as a matter of policy that would date from March, 1970.

Guidelines of Good Corporate Citizenship

A further response to growing foreign control was the issuance in 1966 of guiding principles of good corporate behaviour for Canadian subsidiaries of foreign firms. These were announced by the then Minister of Trade and Commerce, the Honourable Robert Winters.

The guidelines provide as follows:

(a) pursuit of sound growth and full realization of the company's productive potential, thereby sharing the national objective of full and effective use of the nation's resources;

(b) realization of maximum competitiveness through the most effective use of the company's own resources, recognizing the desirability of progressively achieving appropriate specialization of productive operations within the internationally affiliated group of companies;

(c) maximum development of market opportunities in other countries as well as in Canada;

(d) where applicable, to extend processing of natural resource products to the extent practicable on an economic basis;

(e) pursuit of a pricing policy designed to assure a fair and reasonable return to the company and to Canada for all goods and services sold abroad, including sales to the parent company and other foreign affiliates;

(f) in matters of procurement, to search out and develop economic sources of supply in Canada;

(g) to develop as an integral part of the Canadian operation wherever practicable, the technological, research and design capability necessary to enable the company to pursue appropriate product development programmes so as to take full advantage of market opportunities domestically and abroad;

(h) retention of a sufficient share of earnings to give appropriate financial support to the growth requirements of the Canadian operation, having in mind a fair return to shareholders on capital invested;

(i) to work toward a Canadian outlook within management, through purposeful training programmes, promotion of qualified Canadian personnel and inclusion of a major proportion of Canadian citizens on its board of directors;

(j) to have the objective of a financial structure which provides opportunity for equity participation in the Canadian enterprise by the Canadian public;

(k) periodically to publish information on the financial position and operations of the company; and

(1) to give appropriate attention and support to recognized national objectives and established government programmes designed to further Canada's economic development and to encourage and support Canadian institutions directed toward the intellectual, social and cultural advancement of the community.

As the guidelines are not in any way compulsory, they constitute only a limited form of moral suasion.

Following Mr. Winters' letter to the 3,500 active foreign subsidiaries (designated within this study as the "reporting subsidiaries"), the co-operation of the larger subsidiaries was requested in providing information that would enable a continuing assessment to be made of their behaviour. About 400 respondents representing nearly 1,000 companies were asked to reply annually to a questionnaire from the Department of Industry, Trade and Commerce which would enable the government to develop a clear understanding of quantitative and qualitative impact of subsidiaries on the Canadian economy.

While most subsidiaries have been willing to cooperate in this voluntary programme, a number have not. Moreover, since the survey does not apply also to Canadian controlled firms, no yardstick exists against which the performance of the foreign controlled firm may be measured. This subject is dealt with more fully in the chapter below on Information.[50]

No evidence is available to suggest that these voluntary guidelines have had a major impact upon the behaviour of foreign controlled subsidiaries. They do not have the force of law. Firms which respond to them may find that they are entering into practices which their competitors are not prepared to make.

Extraterritorial Application of Foreign Law

As discussed elsewhere[51] on a subject-by-subject basis, the federal and provincial governments have taken measures or passed laws to deal with certain problems relating to extraterritoriality. Some of the provinces have passed laws dealing with the summoning of Canadian business records by foreign authorities. The federal government has arrangements mitigating the impact of United States antitrust and trade legislation on Canadian subsidiaries and the proposed Competition Act would be of further assistance in this regard. All these measures are aimed at reducing certain political and economic costs associated with foreign investment.

Other Measures

Other measures aimed at improving the benefits of foreign investment in the resource field have been taken by provincial governments. These are referred to below.

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[50] See Chapter Twenty Two.
[51] See Chapter Sixteen.

Tax Law

Under the new tax law, several measures have been introduced which are aimed at encouraging Canadian ownership. The dividend tax credit or dividends paid by taxable Canadian corporations has been increased (without regard to the location of control of the corporation); the small business incentive is available to Canadian controlled private corporations only and must be repaid if the firm is transferred to non-Canadian control, thus directly favouring Canadian controlled corporations; withholding taxes on dividends paid to non-residents will continue to be five per cent lower for corporations having a degree of Canadian ownership. Pension funds must retain ninety per cent of their assets in Canada to avoid paying a special tax of one per cent per month on that proportion of their assets abroad in excess of that amount, thus encouraging these institutions to invest Canadian savings in Canada. (Although such funds may go into Canadian investments—regardless of the country in which they are controlled—hopefully they will provide some benefit to Canadian controlled business.) In addition, Canadian corporations are able to deduct as an expense the interest paid on funds borrowed to finance the purchase of shares in other corporations. Federal estate taxes have been eliminated, thus potentially reducing the sales of private Canadian corporations which are alleged to take place in order to raise funds to pay these taxes (although capital gains taxes will be payable on death).

Canada Development Corporation

The most recent response of the Canadian government to the growing degree of foreign control has been the introduction of legislation to create the Canada Development Corporation (CDC), which was approved by Parliament in 1971.

The purposes of the CDC are to help develop and maintain strong Canadian controlled and Canadian managed firms in the private sector of the economy, and to give Canadians greater opportunities to invest and participate in the economic development of Canada.

The CDC will seek to achieve its first objective by investing in the equity of existing corporations, by assisting in the expansion and establishment of significant new enterprises and in the expansion of existing ones. In doing so, it will normally invest in enterprises in which it expects to have a substantial holding of shares carrying voting rights and in which the total value of the shareholders' equity will be, or is likely to become, $1 million or more. It is expected that the CDC's investment in another business will normally be large enough, either alone or in combination with other Canadian investors, to ensure Canadian control. The CDC will, of course, be in a position to exercise the degree of influence on the basic policies and direction of such businesses appropriate for a major shareholder.

The CDC is expected to work very closely with other members of the Canadian business and financial community, concentrating the exercise of its own direct entrepreneurial functions in those areas of peculiar promise and interest to the Canadian economy where there is not otherwise likely to be a sufficient degree of Canadian participation. In this connection, it will be recalled that in the discussion of capital markets above,[52] emphasis was placed upon the lack of entrepreneurship in the financial institutions. As now contemplated, the CDC seems likely to concentrate its activities on the gaps in the capital markets for large resource projects and for fairly substantial manufacturing investments, rather than for smaller venture capital situations. It should help provide some of the financial and industrial intermediation lacking in these areas, though it is doubtful that any one institution could provide all that is needed.

The CDC may give special attention to industries considered to be of greatest potential and importance to Canada's future economic development. It may emphasize areas involving the development and application of new technology, the exploitation and utilization of Canadian natural resources, those of special relevance to the development of the North, and those areas in which Canada now has or can develop significant comparative advantage by international standards. In doing this, it may help to secure for Canada the headquarters of Canadian-based multinationals which might otherwise be pulled from their Canadian roots. Simultaneously, the Corporation may help overcome the danger of the orientation of Canadian multinationals gravitating gradually to those countries where the largest market is located (usually the United States).

The CDC is not expected to make investments which do not meet its criteria for profitability. This means that there are limits to what the CDC can be expected to accomplish in promoting greater ownership and control of the economy by Canadians. If the Canadian government and people attach high priority to more Canadian ownership, other measures obviously will also be needed.

PROVINCIAL GOVERNMENT RESPONSES

With the exception of legislation limiting foreign control of Ontario, Manitoba and Alberta incorporated trust and loan companies, and businesses engaged in the wholesaling and distribution of paperbacks and periodicals in Ontario, there do not appear to be any provincial laws which limit or prohibit foreign control of Canadian firms—although some have legislation affecting ownership of land. Ontario and Quebec, and other provinces to a lesser degree, have been reviewing the position in respect of ownership in the securities industry. Ontario has also taken some other measures aimed at improving performance of some firms, including foreign controlled ones. Most important in this respect is the legislation giving the provincial govern-

[52] See Chapter Seven.

ment discretionary power to require further processing of natural resources, although thus far it has not been enforced very rigorously. More recently, it has been announced that a special venture capital fund would be created by the Ontario government to assist Canadian entrepreneurs and Canadian controlled enterprises.

The Province of British Columbia has also passed discretionary legislation providing for a greater degree of processing of minerals and forest products.

The Province of Quebec has a new policy with respect to book publishing which may have some influence upon the ownership and control of that industry. In effect, it would appear that all Quebec institutions (e.g., school boards, libraries, hospitals) receiving grants from the Government of Quebec will be obliged to purchase all their books from government approved publishers. These publishers will have to be at least fifty per cent controlled by Canadians resident in Quebec and the publisher will have to have his headquarters in that province.

The Ontario Government has provided financial support for McClelland and Stewart, thus indicating its concern about the ownership and control of the book publishing industry.

CONCLUSIONS

An essentially open framework has been the central plank in past policy toward foreign investment. At the same time, public investment has helped to ensure a large Canadian presence in certain industries. Restrictions on foreign control, to one degree or other, have also been introduced in certain key sectors of the economy. These have been applied largely in response to fears of foreign takeovers. Various efforts have been made to improve the performance of foreign controlled firms in Canada. On the whole, these have been of only limited effectiveness.

Finally, some efforts have been made to stimulate Canadian ownership, but to date they do not appear to have had any substantial impact on the pattern of ownership in the economy.

POLICIES OF OTHER GOVERNMENTS TOWARD FOREIGN DIRECT INVESTMENT

INTRODUCTION: PURPOSE AND METHOD

This section describes in general terms the kind of approaches other governments have taken toward foreign direct investment. The purpose is to provide some idea of the range of policies which prevail abroad and the instruments used to implement them. The countries examined include eleven advanced or relatively advanced industrial countries of Western Europe, the United States, Australia, South Africa, Japan and Mexico.

There are four considerations which must be taken into account in assessing the findings below. The first is that, in relation to the size of their domestic economies, none of the countries has experienced a degree of foreign control which begins to approach the Canadian situation. The reasons for this vary from case to case. At least two of the countries—Norway and Mexico—appear to have devised restrictive policies at some point in the past because of a particular fear of extensive foreign control by a neighbouring country.

On the other hand, a number of these countries do have a high degree of foreign control in certain high technology and other capital intensive industries. The German petrochemical industry and the British automobile industry, for example, are largely controlled from abroad. But, on the whole, no other country has a situation resembling the Canadian picture.

Secondly, most of the countries surveyed adhere to the OECD Code for the Liberalization of Capital Movements. As they have accepted, in principle, the desirability of freeing capital movements, they normally tend to emphasize the more open aspects of their policies. While Canada is more liberal than most other countries, Canada alone among the OECD countries does not adhere to this Code.

Thirdly, these countries include the world's largest exporters of capital, including the United States, United Kingdom, Germany, Switzerland, Sweden and The Netherlands. As such, they have important vested interests in striving for relative ease of access for the intended overseas investments of their nationals and for ease of repatriation of profits. To varying degrees, this fact serves as a liberalizing pressure in respect of their policies towards capital imports. It seems also to lead them to take a relatively relaxed attitude about the practices of multinational enterprises.

Finally, all countries studied—except the United States, Germany and Switzerland—have in place a foreign exchange control apparatus. Some use it restrictively, others more liberally. Exchange controls were not implemented in these countries with the primary aim of preserving domestic ownership and control of the economy, but rather for balance of payments reasons. As balance of payments considerations have permitted, most countries have generally tended to rely progressively less on the exchange control mechanism in dealing with current payments. However, as an outgrowth of their earlier balance of payments problems, most countries do have the experience of a foreign exchange control apparatus capable of regulating capital imports.

As each of the countries studied has its own historical experience and special peculiarities, each policy is unique. However, for summary purposes, certain arbitrary lines can be drawn to provide an overview of other countries' policies.

It will be noted that some countries are discussed under more than one of the policy headings below as elements of their practices make it difficult to put the country under any single one. The headings are:

(i) Open or Very Open.

(ii) Countries Wishing to Attract Foreign Investment, but Which Bargain about Terms and Conditions of Entry.

(iii) Countries Seeking to Protect Key Sectors.

(iv) Restrictive.

POLICY APPROACHES

Open or Very Open

Countries which have very few restrictions on direct foreign investment include the United States, The Netherlands, West Germany, Denmark and Australia. It should be noted that the first three of these countries are important capital exporters or have major investments abroad. The United States is, of course, the largest capital exporter and bastion of the multinational enterprise and as such had been a proponent in the past of freer movements of capital.

The West German economy is also based upon liberal economic principles. Broader geo-political reasons may also have strengthened the German willingness to welcome investment from other countries.

The Netherlands is both very anxious to attract foreign capital for economic and regional development purposes and to protect the enormous investments of its multinational giants abroad, such as Shell, Unilever and Phillips (which are partially controlled in The Netherlands). Denmark and Australia are also anxious to attract foreign capital for economic development purposes.

At the same time, through one device or another, even these countries have from time to time made it difficult for foreigners to invest in particular industries.

Countries Wishing to Attract Foreign Investment, but Which Bargain about Terms and Conditions of Entry

Some countries discussed under this heading are relatively liberal; others are much less so. The main point here is that each uses the apparatus available to it to negotiate to meet the needs of its own economy. The United Kingdom (a major exporter of capital) formally prohibits all investments until the conditions it sets are met and this occasionally involves discussions between the United Kingdom authorities and the investors about a variety of factors in important cases. Similarly the Belgians and the Italians seek to attract foreign investments to one degree or other but bargain at times (but by no means on all foreign investment) to improve the contribution which the investment will make to their particular needs, e.g., bargaining for commitments for export performance and for location in a designated area. Less directly, the Australians seek to convince foreign investors of the desirability of allowing Australian equity participation by regulations affecting access to their capital markets, as outlined more fully below.

France's policy has varied through the last ten years and has normally been rather more nationalistic than the above countries. However, France also bargains about the terms and conditions of foreign entry. Norway's position is in some respects similar to that of the French. The principle, in each case, is that while the foreigner has something of value to the host economy, the host also has an asset the foreigner wants—easy access to its domestic markets.

Countries Seeking to Protect Key Sectors

Some of the countries listed below have been or will be referred to under other categories also. The principal countries here are Sweden and Norway, both of which claim to be very liberal, but which in fact exclude or restrict foreign investment across wide and important parts of their economy, especially in resources. In addition, Italy, Austria, France, the United States and Australia have lesser but still fairly significant parts of their economy which are closed to the foreign investor, or in which the foreigner can obtain only restricted access.

In contrast, the United Kingdom, Denmark, Belgium, West Germany and Switzerland rely very little on this kind of approach. The selection of key sectors, where this is an important policy element, seems to be based on a few, clearly defined criteria and the considerations apparently vary widely from one country to the other. Sectors most frequently designated include banking, insurance, parts of communications and transportation, including public utilities and natural resources.

Restrictive

The prime examples of restrictive policies are those followed by Mexico and Japan, both of which have a very substantially different historical and cultural experience than the other countries considered here. In Mexico, where there was substantial foreign ownership prior to the 1910 revolution, foreign capital is permitted only as a supplement to internal savings.

In Japan, where the foreigner has traditionally been suspect, every effort has been made to hold out foreign participation for as long as possible in order to give domestic industry an opportunity to prepare for competition on an international basis.

In the case of both Mexico and Japan, the degree of foreign investment is very small. It must be further noted that in the case of France, Sweden and Norway there is a strong desire to ensure that ownership of a fairly wide sector of the economy remains in the hands of the nationals. In all cases, it is apparent that the reasoning is largely due to politico-strategic and/or cultural reasons, and relates rather less to overall economic performance. At the same time, one would be hard pressed to demonstrate conclusively that these economies suffered as a consequence. Indeed, there appears to be little correlation between national economic performance and the degree of a country's liberalism or restrictionism in respect of direct investment inflows.

There are aspects of the experiences of other countries which are being examined as part of the Canadian review of policy and which, therefore, merit further comment here.

A General Review Provision

Some form of review of foreign direct investment appears to be employed in Norway, France, Japan, Mexico and the United Kingdom, and to a lesser extent in Italy, Belgium, Sweden, Denmark, Austria and Australia. In most instances, a foreign exchange control apparatus exists with which to back up statutory requirements about notifications of foreign investment.

In some cases, the review mechanism serves to prevent foreigners from making direct investments in particular industries; that is, permission for such investment is not granted. In Norway and Sweden, for instance, it appears that it is virtually impossible for a foreigner to gain control of wooded lands or paper mills, even though these apparently are not, in any formal sense, key sectors. In Italy, investments may be turned down if the foreigner wishes to invest in an industry in which state ownership is extensive. In other countries, the need to obtain government approval enables the recipient country to bargain about local equity participation, export undertakings, the presence of nationals on the board of directors, location of plant, procurement of services, or whatever other considerations the recipient country judges relevant.

For instance, in Japan the review process begins with the Bank of Japan, which has control of the exchange control apparatus. The Bank requires relevant information from would-be foreign investors. It then passes the information to the various ministries concerned, which, in turn meet at a senior interdepartmental level. The file is then passed to the Foreign Investment Council, which includes businessmen, journalists and academics, before a recommendation is made to the Minister of Finance. Changes in the terms and conditions are sometimes negotiated prior to ministerial decision.

A similar approach is followed in France, but with greater emphasis on bargaining and less on rejecting investments. In France, this extends to reviewing licensing agreements (e.g., on technology) to ensure that the terms are reasonable.

In the United Kingdom performance undertakings are sometimes sought in cases of major takeovers. For instance, in the 1967 acquisitions of Rootes by Chrysler and of Pye by Phillips, undertakings were obtained to maintain or to increase exports. On new investment, the United Kingdom does not seem to intervene frequently, if at all.

Domestic Borrowing Restrictions

Many countries have requirements respecting non-resident direct investment under which all or a part of it must be financed abroad. Such policies

are normally justified on balance of payments grounds. In some cases this applies to all investments; in other cases it may apply only to takeovers. The access of non-resident controlled companies to domestic money markets for working capital or for capital for investments in new fixed assets may also be subject to limitation.

In the United Kingdom, takeovers are expected to be entirely financed from abroad and new foreign controlled firms are also expected to be largely self-financing. In France, takeovers by non-resident firms of French companies must be entirely financed from abroad; for new enterprises, at least fifty per cent of the financing must be non-French.

In Italy, investments are divided between "productive" and "non-productive". Foreign investments which do not involve creation or expansion of production facilities—for instance, the purchase of existing shares (a share swap or other form of takeover)—are normally deemed to be non-productive. Non-productive investments are discouraged by limiting free transferability abroad of interest, dividends and profits. They are also discouraged by limiting retransfer abroad of the original investment to an amount not exceeding the amount of foreign currency originally imported. It appears also that "productive" investments are freer to raise capital on the Italian capital markets than are "non-productive" investments.

In Australia, local borrowing by firms are affected by the extent of Australian equity participation in the economy, and in Norway the acceptance of a foreign investment is also affected by the amount of capital imported. There also seem to be similar provisions in South Africa, Mexico and Japan.

In all cases, the aims seem to include one or more of the following: to strengthen the balance of payments; to use this as an indirect means of discouraging foreign investment or of channelling it into those industries where the host government wishes it; to encourage foreign firms to provide for equity participation by the nationals of the host country, and possibly to prevent displacement of local borrowers.

OTHER TECHNIQUES FOR RESTRICTING FOREIGN INVESTMENT

Several countries have in their companies' legislation provisions which bear on foreign investment. Swedish firms have the right to limit, through their articles of association, the right of non-Swedish nationals to acquire shares in the company. In these cases, non-Swedes are normally restricted to twenty per cent interest in aggregate. In practice, 39 of the 40 largest Swedish companies have made use of this provision and thus effectively prevented foreigners from acquiring control.

In Switzerland, corporations can issue their common shares in three forms. "Participation shares" enable a shareholder to participate equally in profits with other common shareholders but not to vote; "registered" common shares are available only to Swiss citizens; "bearer" common shares may be held by citizens of any country. The latter two types have voting

rights. Registered shares are always in the majority, thus precluding the acquisition of Swiss firms by foreigners. Japan also requires that companies have different categories of shares, with foreigners being permitted to purchase only a designated category.

Restrictions on the purchase or lease of real property by non-nationals in Norway, Denmark, Sweden and Switzerland provide the authorities in those countries with the opportunity to bargain over terms or to restrict foreign investment. The extent to which this actually occurs is difficult to document.

TAKEOVERS

In general, national governments tend to distinguish between takeovers by foreigners and the starting up of new enterprises by foreigners. Even some of the more liberal countries, such as West Germany and Australia, have prevented takeovers through ad hoc administrative practices. The Belgian government reviews takeover bids for companies whose shares are publicly traded. In Italy, as already indicated, a takeover is normally deemed to be "non-productive" unless the enterprise purchased is to be expanded by the acquiring firm. Such non-productive investment is likely to be discouraged through restrictions on the access of such firms to the domestic money markets for loans, and through limitations on repatriation both of profits, interest, other current payments and of the capital investment itself.

France requires that foreign takeovers be financed entirely through foreign currency. In addition, it has used its review authority to discourage takeovers.

In Switzerland, requirements for nationals on boards of directors, limitations on work permits and land permits, and the technique of using different categories of shares which was referred to above, all make takeovers very difficult.

The constrained share status of almost all leading Swedish companies is an important barrier to the takeover of Swedish firms. Takeovers of Japanese firms are not permitted. In Australia, the government has a policy under which it will intervene to prevent takeovers which are considered contrary to the national interest.

The general philosophy which underpins each of these countries' policies includes one or more of the following: a nationalistic opposition to foreigners; a desire on the part of domestic corporate management to fend off foreign takeovers; a government wish to channel foreign investment into areas where it will be most productive, which means into new investments rather than acquisitions; allowance of takeovers only after negotiations on performance have been successful.

KEY SECTORS

Owing to the widespread restrictions on foreign investment in Mexico and Japan, the key sector analysis cannot be readily applied to those two

countries. In Japan, however, even after its recent round of liberalization, distinctions between various categories of industry continue to be made by Japanese authorities.

Sweden and Norway restrict foreign control in real property, waterfalls, minerals, forest resources and shipping. Denmark restricts foreign participation in financial institutions and farming. The French are most concerned about electronics, information software and automobiles, and west Germany is concerned about oil refining, automobiles and electronics. The Italians protect banking, insurance, finance, shipping and air transportation; the Australians banking and broadcasting. In the United States, foreign participation is prohibited or restricted in shipping, broadcasting, communication satellites, hydro-electric power or activities associated with atomic energy and banks. In addition, some countries have "catch-all" phrases relating to strategic industries. Moreover, foreigners are excluded from many other industries because of the existence of state monopolies.

The reasons why other governments designate key sectors is seldom made clear. In some cases it obviously reflects historical concern about what were, in the past, industries of great strategic importance, either for military or economic reasons. Thus, most countries ensure that key financial institutions, communications and transportation facilities are under the control of their citizens.

The other general reason seems to reflect a concern about the high technology, high growth industries which may dominate the future. Governments apparently believe that a strong indigenous capacity is important for their national interests. The dilemma here is that it is often the large foreign multinational enterprise which has the most up-to-date technology and is able to make a product available at prices which, in the short run at least, are less than the cost of indigenous development.

MANDATORY HOST COUNTRY SHAREHOLDINGS

Mandatory local shareholdings is not an issue in Mexico, where the law requires that local shareholders retain a half or more of the shares in virtually all cases, even though the Mexican partners at times may not participate actively in the direction of the enterprise. In the case of Japan, even in those industries which are now liberalized, there is a preference for Japanese shareholdings and in many industries fifty per cent or more Japanese equity remains a legal requirement.

In general, nearly all but the most liberal governments tend to look more kindly upon foreign investments in which opportunity is provided for domestic equity ownership—either on a partnership basis or with large single owners.

Thus the French or Italians will be more likely to approve a 51/49 or 50/50 venture than one in which no domestic participation is proposed. Even where investments are permitted, access to local borrowing may not be allowed in the absence of large local shareholdings.

On the other hand, it appears that only Australia attaches importance to local portfolio shareholdings in foreign controlled firms. The degree to which these portfolio holdings are permitted determines whether foreign controlled firms may borrow money in Australia.

BOARD OF DIRECTORS

Many countries require a majority of nationals on boards of directors. They include the three Scandinavian countries which are examined here. The Australian Government emphasizes the importance it attaches to having Australian nationals on boards of directors and in senior management. It does not require this by law, but creates some pressures to obtain such representation. Where foreigners are entitled to up to fifty per cent of a Japanese company, management remains entirely Japanese and the percentage of Japanese equity must carry with it an equal number of Japanese directors.

The British also prefer to see a majority of their nationals on boards of directors and while information is not available on some of the other countries, the availability of a bargaining tool has probably led some of them also to impose such requirements.

CONCLUSIONS

The foregoing outline illustrates the wide range of approaches to foreign direct investment adopted within the western economic system and the variety of instruments available for the implementation of government objectives.

Generally, most countries seem to have a sense of national interest in the economic sphere, however inarticulate it may be. What it seems to say is that business enterprise is most easily made to serve the national interest if owned and run by nationals.

Perhaps the single most common instrument which other countries use in dealing with foreign direct investment is some form or other of review or screening mechanism. In some countries, it is used very infrequently as an instrument of intervention. In other cases, the screening mechanism is used more often—either to restrict or to bargain, or both. The review mechanism provides a national government with flexibility to consider foreign direct investment on a case-by-case basis and the vigour with which a review process is applied can be made to vary over time.

In describing the general approach of many other governments toward foreign direct investment in their country, it is by no means intended to suggest that their policies are necessarily optimal ones, or that these countries have defined their national interests in a way which is appropriate to the circumstances of today. The point is, whether one approves or disapproves of the policies, they do represent a national viewpoint.

In recent years, there has been an international trend toward the reduction of barriers to investment flows and increasing non-resident ownership and control of certain industries in a number of countries. This tendency has been

due in large part to political pressures exerted by capital exporting countries on the governments of the countries in which they wish to invest. The economies of scale in certain industries, particularly the very high costs of research and product development and innovation in certain high technology industries, have also had an important bearing upon the tendency toward greater foreign ownership and control, a case in point being computer hardware in some Western European countries.

There is thus a tendency toward liberalization, but the pace is slow and uneven. Nor is the liberal trend necessarily a continuous process. Even in the most liberal countries it is likely that if there were risk of widespread foreign control a halt would be called. This may be reading too much into the policies of other countries, but from isolated measures of the more liberal countries it would appear to be the probable outcome.

Chapter Twenty One

THE USE OF GOVERNMENT PROCUREMENT, GRANTS AND LOANS, AND TAX POLICY IN THE CONTEXT OF FOREIGN INVESTMENT POLICY

In this chapter, consideration is given to government policies relating to procurement, grants and loans, and taxation. It examines the ways in which these policies affect the ownership pattern of the Canadian economy and deals with the extent to which these policies or programmes benefit Canadian, as opposed to foreign controlled, firms. It also considers whether there should be a bias in these policies or programmes in favour of Canadian controlled firms, either as a means of increasing Canadian ownership and control of Canadian businesses or as a bargaining lever to enhance the government's ability to influence the performance of foreign controlled firms.

GOVERNMENT AND CROWN CORPORATION PROCUREMENT

INTRODUCTION

It has been estimated that over $5 billion is spent annually for the procurement of goods and services by federal, provincial and municipal governments—exclusive of property, construction and building materials. Of this amount, around forty per cent is purchased by the Department of Supply and Services and other federal government departments and agencies, including Crown corporations.

No systematic data are collected on the extent to which these contracts are provided to Canadian controlled firms. But because it is such a large purchaser, it is possible, at least in theory, for the federal government to use its purchasing power for either or both of the two objectives referred to above—to increase Canadian control of Canadian business or to bargain for better economic performance by foreign controlled companies.

With respect to the first possibility, federal expenditures are sufficiently large that they might have an impact on the pattern and extent of foreign control of Canadian business enterprise. In the extreme, the federal government theoretically could prohibit all purchases of goods and services

from foreign controlled firms, although this is obviously not a practical alternative. The issue considered here is how far down such a path it might be reasonable to go in order to increase Canadian control of Canadian business.

Similarly, it is important to consider whether, and in what circumstances, procurement should be used as an instrument to bargain for better performance.

The conclusion reached is that consideration might reasonably be given to employing government procurement policy to increase Canadian ownership and control, provided that it were done on a selective basis. This might be the case in industries where industrial development strategy suggested that Canadian ownership and control were desirable, where government purchasing was sufficiently large in that sector to have a significant impact on its pattern of ownership—and if the degree of discrimination were not excessive. With these exceptions, however, discrimination in favour of a Canadian controlled firm seems appropriate as a general rule only where all other aspects of competing bids are equal. If some form of quantitative preference were given to Canadian controlled firms in all cases, the cost would likely be unduly high.

THE AIMS OF PROCUREMENT POLICY

The primary function of a procurement policy should be to obtain the best value for money spent. This involves identifying reliable sources, securing the lowest possible price subject to reasonable assurances in respect of quality, delivery and service, and performing these functions with the lowest feasible administrative cost.

For certain kinds of uniform mass-produced items which are readily available from alternative sources, this essentially may means obtaining the lowest possible price through competitive tender. For other more complex products, such as the purchase of a sophisticated new weapons system, there is the need for much greater discretion as numerous factors must be taken into account, including performance characteristics, costs, date of delivery, security of supply, and so on. Notwithstanding these additional complexities, it can again be argued that the function of the procurement agency should be to minimize the price in relation to the likelihood of the product meeting the objectives of the user department or agency.

Substantial deviations from these principles involve several risks. They leave open the possibility that in the pursuit of other government objectives, the needs of the user department may not be satisfied fully. Secondly, they may also mean sharply increased costs to the federal treasury and taxpayer as a consequence of a reduction in the cost-consciousness of the buyer. Thirdly, as the criteria for procurement become more diverse and compli-

cated, the discretion of the procurement agency may be so widened that it becomes too difficult to develop objective standards for evaluating contracts awarded by the buying agency.

On the other hand, government purchasing can, in practice, either complement or conflict with other government policies or programmes. If procurement policy were to ignore entirely this fact, decisions taken could be very costly when account is taken of all relevant factors. In taking into account other government objectives, however, policy on procurement should aim to be as precise as possible, and to quantify wherever possible, so that the risks noted above are minimized. If this is not done, the job of the procurement agency becomes much too complex.

PREFERENCES FOR CANADIAN FIRMS

Notwithstanding the arguments in favour of a "best-value-for-dollar-spent" approach to procurement, the present government purchasing system, in fact, contains exceptions to this method to meet other government objectives. For instance, because of government concern about the level of employment, preference for Canadian content may be given through procedures governing source of supplies both in the cost of government departments and certain Crown corporations. The procedures are usually established on the basis of administrative rulings, by Treasury Board in some cases, but more usually by the operating department or Crown corporation. Normally, an effort is made to obtain a sufficient number of bids to establish "competition", but an upper limit on the number of bids may also be set to reduce time required to evaluate them. As a generalization, in cases where goods are easily specified and available from a number of sources, buying agencies will purchase by soliciting all those firms which have expressed an interest in bidding on the particular item required. The other end of the "sourcing" spectrum is the case where there is only one supplier who can meet the specification for the merchandise in the required time frame. In buying custom-built equipment or equipment having a high engineering content or high technical risk, it is common practice to solicit bids selectively from five or six firms based on an analysis of the equipment required and of the qualifications of the individual firms in terms of management, engineering, production, quality control and service.

Federal departments and Crown corporations normally restrict their purchasing to Canadian sources where this is reasonably possible. Such sources may simply be a sales agent representing a foreign manufacturer. However, even in these cases, the agent may also provide technical services or repair and overhaul facilities if the type of equipment being purchased requires such "after sales service". If it appears that there will be a large volume of business available in the future for particular imported items or types of items, departments have traditionally encouraged increasing degrees

of manufacture in Canada as business volume grows. This approach, in the context of the industrial development and defence strategies of that period, explains a large part of the growth of the Canadian electronics and aircraft industry during the 1950's.

In addition to sourcing in Canada wherever practicable, departments use Canadian labour and materials wherever possible, subject to the qualifications that no more than ten per cent premium should be paid for Canadian content. The Canadian labour and materials clause is in the standard form for government construction contracts. The prohibition is only against exceeding a ten per cent premium without Treasury Board approval. It is not explicitly an order to spend up to ten per cent more whenever this will increase Canadian content. And in some cases where foreign bids have been allowed by departments, despite the allowance and any tariffs applying to imported goods, Canadian controlled firms have been unable to secure the contract.

Aside from the ten per cent allowance and sourcing preference, other considerations at times also influence procurement. One of these considerations relates to the need to maintain an essential defence base in support of the Canadian Forces. Other considerations relate to specific commodities, such as coal, which, from time to time have been protected in support of national goals.

In general, there have been very few explicit conditions placed on Crown corporations to bias their procurement policy toward Canadian suppliers. The ten per cent clause has had even less effect on the corporations than on the departments, because of their greater degree of independence.

SHOULD PROCUREMENT POLICY DISCRIMINATE IN FAVOUR OF CANADIAN CONTROLLED FIRMS?

While past preferences in procurement have been aimed at Canadian content, not country of control, it would be technically feasible to build a preference for Canadian controlled firms into government procurement policies so long as a clear cut definition of control were provided to the administrators of the programme. It might also be necessary to put the onus on the firm bidding to demonstrate that it is Canadian controlled, so that this task does not fall to the Department of Supply and Services, in as much as control can change rapidly, and the administrative task of policing all such changes on a day-to-day basis would be enormous. It would also be necessary for wholesalers who supply the government to demonstrate that the products they are providing are from Canadian controlled firms. The absence of satisfactory evidence would not, of course, render a firm ineligible to supply—it would simply deprive it of the preference given to Canadian controlled firms.

While preferences could be given in favour of Canadian controlled firms, the question would still remain as to whether this would be an

effective instrument for increasing the degree of Canadian control in the economy. If the preference were absolute—that is, if foreign controlled firms were not permitted to bid—discrimination would be effective if the industry were at all reliant upon government contracts. But in many instances the price would be enormous. To take an extreme illustration, if the government were to insist today that all future purchases of aircraft by the Canadian Forces and Air Canada be from firms which are Canadian controlled, this would in turn necessitate the establishment of a Canadian controlled, capital intensive, technically advanced industry with the kind of capacity that does not now exist in Canada. For the indefinite future, this could require hundreds of millions of dollars of annual subsidies to meet the Canadian ownership and control objective.

Leaving aside this extreme case, the first realistic policy alternative which could be considered is whether there should be a generalized preference in Canadian government and Crown corporation procurement policy in favour of Canadian controlled firms. This might, in effect, provide for a ten per cent or greater preference for Canadian controlled firms over and above that which is now given for Canadian material and labour; that is, the directive that no more than a ten per cent cost penalty should be accepted for Canadian labour and materials would be modified to allow for up to an additional ten per cent cushion if the firm were Canadian controlled. This would enable Canadian controlled firms to be as much as twenty per cent above foreign bidders. This approach could be integrated into a one-step formula including labour, content and control.

Such discrimination would compel the government to pay higher prices for goods and services in many more instances than is now the case. Moreover, with such a general rule, it would be very difficult to predict the total annual cost to the Treasury, though it is more likely to be in the tens of millions rather than hundreds of millions of dollars.

It would also be difficult to predict the influence of such a proposal on the degree of foreign control. Clearly, however, if it were only to increase federal costs by $20 or $30 million, it would not lead to a very profound increase in the overall level of Canadian control in the economy, although it could contribute to the viability of some Canadian controlled firms.

A more cautious approach might nonetheless be worth considering. In addition to the idea of selective discrimination, which is outlined below, it would be possible to allow for discrimination in favour of Canadian controlled firms where all other aspects of a bid are equal. This would apply most readily to undifferentiated products, where the possibility of very close bids is not unrealistic.

While preference for Canadian controlled firms would be possible when bids are otherwise identical, this is not likely to have an important impact. On the other hand, this could be supplemented by a selective discrimination of a more substantive nature. There are several arguments that can be advanced in favour of this procedure.

In some cases, it may be that the imported merchandise or the merchandise manufactured by Canadian subsidiaries of foreign companies is not suitably designed for Canadian needs, as foreign firms do their research and innovation in another environment and may not take into sufficient account the Canadian situation. If Canadian needs were not likely to be satisfied, then this could constitute an argument for the government, at least initially, to subsidize Canadian controlled firms through procurement preference to give support to the development of a particular industry in this country under Canadian control.

Any step to provide a preference for Canadian controlled firms should only be considered against the backround of the government's industrial development strategy and its policy towards a particular sector. If the sector in question were one with good growth prospects and in which Canada could achieve the economies of scale, then this might well be a situation in which national industrial policy would favour Canadian development. It might also favour granting a preference for Canadian control to minimize the possibility of truncation and blunting of the entrepreneurial and innovative thrust. Even in this situation, however, some limit would have to be put on the amount of subsidy which would be tolerated.

If distictive Canadian needs and other factors relating to industrial strategy supported the provision of a degree of procurement preference, it would still be necessary to consider whether preferences for Canadian controlled firms would likely change the ownership pattern in that sector. Clearly, the major variable here is the leverage which the government has on the sector. If it depends on government contracts for a substantial degree of its output, then obviously a preference for Canadian controlled firms would open the possibility of allowing such firms to grow more rapidly than the foreign controlled firms. If such leverage were available, then little signifiant impact could be expected.

The main factors to be taken into account in determining whether procurement preferences are rational thus include: the government's industrial development strategy; the leverage the government has on the sector; the need to be able to measure the amount of subsidy.

SPECIFIC INDUSTRIES

Set out below are data on four industries in which the government and/or Crown corporations are particularly large customers. They are: aircraft, communications, railroad rolling stock and scientific and professional equipment. While the shipbuilding industry is not one for which data are readily available, the government and Crown corporations are also particularly important buyers of its production.

The data below, showing government procurement from these industries, are not precise, but they do indicate rough orders of magnitude.

By the end of 1969, Air Canada had made further payments of $81.6 million against orders, opinions or delivery positions for acquisitions of property and equipment. Major contractors here are Douglas, Boeing and Lockheed.

The total procurement figure in Table 48 is used as an indication of leverage. It includes imports as well as domestic expenditure.

TABLE 48

AIRCRAFT AND PARTS PROCUREMENT

	(1)	(2)	
1967	Procurement	Value of Shipments—Canada	(1) as % of (2)
	$	$	
Air Canada	116,460,000		
DSS†	413,090,000		
CIDA‡	572,300		
	530,122,300	610,210,000	87
1968			
Air Canada	134,370,000		
DSS	189,475,000		
CIDA	859,400		
	324,704,400	674,549,000	48
1969			
Air Canada	118,080,000		
DSS	265,411,000		
CIDA	2,688,700		
	386,179,700	621,291,000	62

†Department of Supply and Services.
‡Canadian International Development Agency.

Communications Industry

Procurement in this field by the Department of Supply and Services (DSS) has ranged from 20 to 25 per cent of the value of shipments over the last four years, with the proportion being on a declining trend. Using most recent available data available for other government buyers, one can add to DSS procurement for 1969 as shown in Table 49.

TABLE 49

COMMUNICATIONS EQUIPMENT PROCUREMENT

Buyer	Amount	Year
	$	
DSS	129,445,000	1969
Dept. of Transport (Air Services Programme)	27,831,000	1968–69
CN Telecommunications	20,253,000	1969–70
CBC (approx.)	12,000,000	1968–69
Canadian Overseas Telecommunications Corp. (approx.)	10,000,000	1969–70
Total	199,529,000	

In 1969 the value of shipments figure for Canada was $657,879,000. The above total for five major government buyers therefore represents thirty per cent of the industry output. Since there may be additional government procurement in this field which is not identified here, the proportion could be somewhat higher.

Railroad Rolling Stock Industry

This classification outlined in Table 50, combines locomotives with all of the various types of railroad cars.

TABLE 50

RAILROAD ROLLING STOCK PROCUREMENT

	(1) Procurement	(2) Value of Shipments—Canada	(1) as % of (2)
1967	$	$	
CNR	81,570,000		
CIDA	11,055,000		
	92,625,000	182,649,000	51
1968			
CNR	71,250,000		
CIDA	6,500,000		
	77,750,000	159,450,000	49
1969			
CNR	52,910,000		
CIDA	9,700,000		
	62,610,000	170,622,000	37

Department of Supply and Services procurement in this field has ranged from four to sixteen per cent of the value of shipments over the last four years, with the trend declining.

Although percentages here are not high, the inclusion of other government buyers would probably raise these figures somewhat. These might include Atomic Energy Canada Limited, Polymer Corporation and the Departments of Energy, Mines and Resources, and National Health and Welfare. At present, however, detailed breakdowns are not available to permit an estimate of their impact in this one area. Nonetheless, the highly specialized nature of the present industry and its potential for rapid growth increases the significance of the above figures in Table 51.

TABLE 51

SCIENTIFIC AND PROFESSIONAL EQUIPMENT PROCUREMENT

	(1)	(2)	
1967	Procurement	Value of Shipments—Canada	(1) as % of (2)
	$	$	
DSS	37,889,000		
NRC† (est.)	4,650,000		
	42,539,000	315,209,000	13.5
1968			
DSS	21,669,000		
NRC (est.)	2,720,000		
	24,389,000	349,821,000	7.0

†National Research Council.

PROCUREMENT AS A LEVER IN BARGAINING FOR PERFORMANCE

Foreign control is high in many industries where government leverage is great, such as aircraft and communications equipment. Therefore, in many industries there will be no viable Canadian controlled firm to bid for a large government contract. The question arises whether government procurement should be used, at least informally, to push for better performance by such industries in Canada. This procedure has, in fact, been adopted from time to time in the past.

In general, there appear to be few arguments against this approach, provided it is focused on large contracts so that procurement officers are not required to engage in bargaining about general corporate performance on routine contracts. Where large contracts are at issue, it seems reasonable—given the wide mix of government objectives—for the government agency awarding the contract to notify both the other government departments most interested, including the review agency—if one is established—in order to determine if the contract award may offer the possibility of better performance from the foreign controlled firm. This might take the form of increased rationalization, removal of export restrictions, or greater procurement of components and services in Canada.

CONCLUSIONS

There is some precedent for Crown corporations and departments using procurement to achieve goals of national policy that go beyond those directly related to the objectives of the buying agency.

Secondly, the need for the government to purchase within some reasonable financial limits reduces the potential effectiveness of the procurement tool for reducing the degree of foreign control. It would also be necessary to consider reimbursing user departments and/or Crown corporation budgets from general government revenue, to the extent that preferences are applied in order that their budgeted expenditures would not be artificially distorted. Such reimbursement would most likely be required in the case of Crown corporations. Current "responsibility accounting" policies now being introduced into the management levels of departments also strengthen the argument for such compensation in this area as well.

Thirdly, a generalized procurement preference for Canadian controlled firms is possible. However, such a shotgun approach could be costly in relation to the return likely to be obtained from it in terms of increased Canadian ownership, unless restricted to a preference only when all other aspects of a bid are identical.

Fourthly, there are sectors of the Canadian economy which are influenced significantly by federal government procurement. The sectors where government procurement is large and might conceivably provide a lever are: shipbuilding and repair; aircraft and parts; some communications equipment; railroad rolling stock; and scientific and professional equipment. These sectors are largely foreign controlled at the moment, but over time some discrimination in favour of Canadian controlled firms in procurement might strengthen Canadian capacities in at least some of the sub-sectors involved.

A task connected with the further development of government industrial policies could be the pinpointings, within these sectors, of which industries might be given the benefit of preference for Canadian controlled firms to best advantage.

A review agency could be advised of large procurement contracts which are awarded to foreign controlled firms, together with other government departments most interested. Particularly if a review agency were given authority to review aspects of existing foreign investment in Canada, consideration could be given to use of procurement as a device for obtaining better performance.

GRANT AND LOAN PROGRAMMES

INTRODUCTION

The purpose of this section is to outline how Canadian government grants, loans, and insurance of loans, are awarded as between Canadian and non-resident controlled firms; to consider the possibility of restricting the grants, loans and loan insurance to Canadian controlled firms as a technique of increasing Canadian control in the economy; and to consider whether such grants and loans can be used as a lever for insisting on performance undertakings by foreign controlled firms, similar to that suggested for the review process.

It is evident that foreign controlled firms benefit substantially from most of these programmes. A balance of various considerations suggests that in cases where fairly specific government objectives exist (such as assisting regional expansion and promoting industrial research and innovation), it would not be advisable to restrict grants to Canadian controlled firms because this would reduce the benefit-to-cost ratio of these programmes. However, one could consider using these grants or loans as a means of trying to persuade foreign controlled firms to undertake or augment the kinds of activity which would improve Canadian industrial performance.

Where the funds of the institution or programme are less closely tied to fairly narrow and specific government objectives, such as those of the Industrial Development Bank or the General Adjustment Assistance Programme, it appears more feasible to consider granting a preference in favour of Canadian controlled firms without seriously jeopardizing the achievement of the policy objectives involved. This would help to overcome gaps in the capital markets which adversely affect Canadian controlled firms and to achieve greater industrial efficiency.

The programmes treated here are those which are administered by the Departments of Industry, Trade and Commerce and Regional Economic Expansion and the Bank of Canada. They are: The Industrial Research and Development Incentives Act (IRDIA); the Programme for the Advancement of Industrial Technology (PAIT); the Defence Industry Productivity Programme (DIP); the Shipbuilding Assistance Programme; the General Adjustment Assistance Programme (GAAP); loans by the Industrial Development Bank (IDB), and regional incentives grants.

THE INDUSTRIAL RESEARCH AND DEVELOPMENT INCENTIVES ACT (IRDIA)

The primary objective of this Act is to induce Canadian corporations to expand scientific research and development likely to result in economic benefit to Canada. Assistance is provided in the form of tax-free, cash grants. Grants are provided for up to 25 per cent of capital expenditures. Grants provided for current costs amount to 25 per cent of the increase of eligible current expenditures made by the applicant in Canada over the average of such expenditures in a base period consisting of the immediately preceding five years.

Corporations applying for grants must certify that they are free to exploit the results of all such scientific research and development in Canada and in all export markets. Where this is not permitted by parent firms, they must state the countries to which they are not free to export. (In practice, unless at least half of the potential world markets are accessible, the grant is not given.)

Canadian controlled firms received about 55 per cent of the monies allocated in the three fiscal years 1967-68 to 1969-70 inclusive.

TABLE 52

IRDIA GRANTS BY COUNTRY OF CONTROL

(thousands of dollars)

	1967–68	1968–69	1969–70	1970–71
Non-resident owned or controlled firms	976.6	8,554.7	9,690.4	19,221.7
Canadian owned or controlled firms	975.4	10,773.6	12,400.1	24,149.1
Ownership unknown	179.3	264.0	909.5	1,352.8
Total	2,131.3	19,592.3	23,000.0	44,723.6

In the fiscal year 1970-1971, $30 million was allocated to this programme. This is less than the amount in the 1969-70 estimates of $37 million, apparently due to the substantial under-utilization of the $37 million provided in 1969-70.

PROGRAMME FOR THE ADVANCEMENT OF INDUSTRIAL TECHNOLOGY (PAIT)

The basic purpose of PAIT is to promote the growth and efficiency of industry in Canada by providing financial assistance for selected projects concerned with the development of new or improved products and processes which incorporate new technology and offer good prospects for commercial exploitation in domestic and international markets.

The programme is administered on a selective basis, having regard to evolving government strategy for industrial development in such matters as specialization and consolidation of product lines. Eligible projects often represent a commitment by an operating company to a promising new product line for which there is an expanding domestic and international market and for which the company will have the technical, financial, managerial, and marketing capability to achieve its stated objectives. Applicants are not automatically entitled to PAIT assistance.

As a rule, the Department of Industry, Trade and Commerce will contribute on a grant basis up to fifty per cent of the total estimated costs of approved development projects, although in some cases the Department may contribute over fifty per cent.

A PAIT applicant company undertakes that the product or process resulting from the project will be produced or used by the company in Canada and that it will, within a reasonable period of time, exploit the results in accordance with sound industrial practice.

The major restriction imposed on the applicant company is the requirement not to transfer technical data or inventions (whether or not patented), methods and processes resulting from the project to any other government or to any person or firm outside of Canada for the purposes of production, without prior government consent.

For the fiscal year 1970-71, estimates for the programme were established at $15.5 million, substantially above the level of expenditure in the previous year. In the past, PAIT funds have been awarded to Canadian and foreign controlled firms in approximately the proportions indicated in Table 53.

TABLE 53

PAID INCENTIVES BY COUNTRY OF CONTROL

	1965–66	1966–67	1967–68	1968–69	1969–70	Total
	$000	$000	$000	$000	$000	$000
Canadian owned or controlled firms	147.0	1,596.3	2,815.6	3,401.0	3,264.0	11,223.9
Non-resident owned or controlled firms	281.2	2,999.7	3,549.3	903.0	2,005.0	9,738.2
Totals	428.2	4,596.0	6,355.9	4,304.0	5,269.0	20,962.1

CONCLUSION REGARDING PAIT AND IRDIA GRANTS

"Benefit to Canada" provisions are included in the PAIT and IRDIA programmes. These seem essential if grants to foreign controlled firms are not to redound primarily to the benefit of foreign parents and foreign countries.

The aim of these grants is to help stimulate research and innovation. They thus provide a lever to help subsidiaries of foreign firms to rationalize and to specialize in particular products for world markets. This is consistent with Canada's present industrial development objectives.

If non-resident controlled firms were not eligible for IRDIA and PAIT grants, certain national economic policy objectives relating to the over-all promotion of research, development and innovation would presumably be sacrificed. The same reasoning applies to any proposal that non-resident controlled firms ought to receive a lower grant than Canadian controlled firms. Hence it is not suggested that these grants be restricted to Canadian controlled firms.

On the other hand, the government might wish to consider whether the awarding of these grants provides an opportunity for getting more from the firms in the way of performance in Canada than the programmes themselves now require. However, no firm rules can be suggested on this matter as this is very much a situation which will vary from one case to the next.

DEFENCE INDUSTRY PRODUCTIVITY PROGRAMME (DIP)

The objective of DIP is to develop and to sustain the technological capability of Canadian industry for the purpose of defence export sales or civil export sales arising from that capability.

Such industrial capability is a means toward four main goals, two of which relate directly to national defence: to minimize cost of acquisition of equipment for the Department of National Defence (DND) by making it possible to develop a yardstick of cost for purchases which must be made abroad to achieve competitive prices; to retain in Canada defence industrial capability for use by DND in servicing and maintaining its advanced equipment; to ensure maximum industrial benefit from the advanced technology and management techniques inherent in defence equipment research, development and production (by making possible competitive participation in foreign markets); and to support cooperative programmes with our allies in military research, development and production (such as the production sharing programme with the United States).

To be eligible, companies must belong to the Canadian defence industry. Assistance under this programme includes product research, development, test and evaluation, and product and process innovation; tooling, manufacture of prototypes, sample batches and all other non-capital cost activities associated with the establishment and qualification of a production source; advanced manufacturing equipment; test and quality control facilities; and data handling equipment. Government assistance is provided through a shared-cost contract. The ratios for the sharing of total approved costs of individual projects can vary widely, depending upon various factors—including the number of participants in the project. In some cases, costs may be shared

by the Canadian government, a company and one or more allied governments. Generally speaking, however, the government matches the company's contribution. Up until 1969, the government share amounted to approximately fifty per cent of the total costs of all development projects under this programme.

The Defence Industry Productivity Programme came into effect in May, 1968, replacing two predecessor programmes—the Defence Development Sharing Programme (DDSP) and the Industry Modernization for Defence Export Programme (IMDEP). The figures below in Table 54 cover the three programmes for the period 1964-5 to 1969-70. For 1970-71, estimated expenditures for DIP were estimated at $60 million.

TABLE 54

DEFENCE PROGRAMME GRANTS BY COUNTRY OF CONTROL

	Number of Firms Benefiting		Amount $000	
Programme	Canadian	Non-Resident	Canadian	Non-Resident
IMDEP	50	38	5,659.7	15,356.9
DDSP	23	29	7,382.5	62,045.9
DIP	62	47	3,528.2	26,060.8
Total	97†	64†	16,570.4	103,463.6

†Net number of firms benefiting; i.e., some firms benefited under more than one programme.

This programme is in large part based on the need to have an industrial defence capability in Canada, the closeness of Canada's defence relations with the United States, and the desirability of keeping Canadian trade in defence products in or near balance. In practice, it is also supported heavily because of a belief that there is much beneficial "spin-off" for civilian industry from this kind of activity and that the cost-benefit ratio (sales generated in relation to grants paid) is very high.

The programme apparently takes careful account of the ability of the recipient to penetrate export markets and to acquire its inputs in Canada. Given the extent to which the Canadian defence industry is already controlled from abroad, and the government's defence policy, it is difficult to see how this programme could be used as a lever to achieve additional Canadian ownership aims without serious cost in respect of these other objectives.

On the other hand, consideration could be given to the award of a DIP grant, as in the case of PAIT or IRDIA, as a lever for bargaining for performance undertakings from foreign controlled firms.

The Regional Development Incentives Act became effective on July 1, 1969. Under its provisions, authority was provided for the Minister of Regional Economic Expansion to authorize payment of development incentives to assist in the establishment of a new facility or the expansion or modernization of an existing facility in a designated region.

Primary development incentives could be authorized based upon the approved capital costs of establishing, expanding or modernizing a facility up to a maximum of twenty per cent of those approved capital costs or $6 million, whichever is the lesser amount.

Secondary development incentives could be authorized based on the approved capital costs of establishing or expanding a facility and on the number of jobs created directly in the operation up to a maximum of five per cent of those capital costs, plus $5,000 for each job created directly in the operation.

Primary and secondary development incentives combined may not exceed:

(i) $30,000 for each job created directly in the operation
(ii) $12 million; or
(iii) one-half of the capital to be employed in the operation, whichever of the three is the least amount.

Under amendments to the Act passed in 1971, a number of changes were made. The $12 million ceiling was removed, Montreal was designated as a special area and it was provided that grants of up to ten per cent of eligible capital cost (plus $2,000 per new job created) could be made there. Increases were also provided for the Atlantic region, so that the differential between Montreal and that area did not change. Finally commercial facilities, such as hotels, were made eligible to receive loans.

The 1971-72 budgetary expenditures for industrial incentives were set at roughly $120 million and provision was made for an additional $6 million in non-budgetary loans. The breakdown between past grants to Canadian and non-Canadian controlled firms is not yet fully available. However, there is no obvious reason to believe that it differs much from the past regional development programmes, for which the breakdown has been very roughly as shown in Table 55.

TABLE 55

REGIONAL GRANTS BY COUNTRY OF CONTROL

	Firms 50% and Over Non-Resident Owned	Firms less than 50% Non-Resident Owned	Ownership Unknown
Number of Grants	73	193	402
Estimated Amount of Incentives ($000's)	91,521	39,814	92,856
Disbursement at December 31, 1969 ($000's)	36,420	16,671	20,369

From the above, it is apparent that probably half or more of the grants under this programme go to foreign controlled firms.

One of the main principles behind this programme is that the grant should compensate firms establishing in regions of slow growth for a proportion of the additional costs which they incur in locating in such an area. In some cases, the grant will be sufficient to affect the firm's location decision; in other cases it will not be adequate and the firm will locate elsewhere. Accordingly, making regional incentive grants conditional upon Canadian control could in some cases lead to the foreign firm locating in Canada, but outside the designated area. The result of such an action would then simply be to hamper seriously the achievement of the programme objectives of the Regional Development Incentives Act. Thus, it is not suggested that regional grants be restricted to Canadian controlled firms.

Similarly, requiring certain forms of behaviour (e.g., in respect of rationalization, exports, sourcing and Research and Development from firms accepting grants would likely decrease the attractiveness of the grant. Accordingly, it is difficult to see how the government could use the grant as a device for imposing performance requirements on one foreign firm, while exempting others not receiving such assistance, without jeopardizing the effectiveness of the regional development programme. However, this does not mean that some bargaining over performance undertakings could not take place in much the same way as it would if a foreign controlled firm proposed to invest in a non-designated region.

SHIPBUILDING ASSISTANCE PROGRAMME

Under the Shipbuilding Construction Subsidy Regulations, subsidies were originally offered to pay 25 per cent of the approved cost of a commercial vessel built in a Canadian shipyard for a Canadian owner, and 35 per cent of the approved cost of a fishing trawler built in a Canadian shipyard for a Canadian owner. However, the subsidy rate for commercial vessels is being reduced by two per cent yearly, reaching seventeen per cent in June, 1972.

Innovative activities which influence the cost of construction of vessels may benefit from this programme.

Under the programme, 53 Canadian and 8 foreign controlled firms received grants between 1965 and 1970. The amount granted to Canadian controlled firms was $104 million and to foreign controlled firms $28 million.

Because of the specific objectives of this programme, including the fact that assistance is directed to particular areas having serious employment problems, it does not appear feasible to restrict these subsidies to Canadian controlled firms at the present time.

However, consideration might be given to requiring notification of the review agency of any grants to foreign controlled firms for purposes of infor-

mation. Consideration might also be given to authorizing the Department of Industry, Trade and Commerce, to the extent feasible, to use these grants to get performance undertakings from foreign controlled recipients.

GENERAL ADJUSTMENT ASSISTANCE PROGRAMME (GAAP)

This program was instituted following the Kennedy Round of international trade negotiations to assist domestic industry in adjusting to its consequences. Assistance was provided to manufacturers to finance the cost of restructuring if they were seriously injured, or threatened with serious injury, by increased imports resulting from reductions in the Canadian tariff as part of the Kennedy Round. Assistance was also available to manufacturers who could not obtain sufficient financing on reasonable terms and conditions from commercial sources to capitalize on significant export opportunities arising out of those negotiations. Subsequently, the programme was expanded to make assistance available to manufacturers of clothing, textiles and footwear to help them improve their competitive position or to adapt to disruptive competition from abroad. (GAAP was expanded again in November, 1971, to include firms whose access to external markets was affected by the imposition of foreign import surtaxes or other similar actions by foreign governments.)

There are three types of assistance that have been made available. They are: insurance on loans provided by commercial lenders for the restructuring manufacturing operations, with the government lender sharing the risk; direct loans; and grants for consulting services.

The insurance provided may be for up to ninety per cent of the amount of the loan. The government charges a fee of one per cent on the amount insured. In cases of direct loans, the interest rate charged on such loans is determined by the General Adjustment Assistance Board within certain statutory limits.

While the benefits of this programme are available to both Canadian and foreign controlled firms, in practice a very high proportion of the $30 million in insured loans thus far provided has been to Canadian controlled firms. This is presumably because the foreign controlled firms generally find it much easier to obtain their requirements in the capital markets or from parent companies, although foreign controlled firms may occasionally seek to participate.

GAAP is concerned with assisting well-managed firms which are unable to raise loan funds—either because of a lack of proven earnings records, or a lack of substantial fixed assets. It has no ceilings on the amount of insured loan it can underwrite for any one firm.

As the government is an insurer or lender of last resort for most firms applying for GAAP assistance, consideration could be given to restricting this programme to Canadian controlled firms without significant reduction in the benefit-to-cost ratio.

Another possibility that could be considered is that this programme be developed into a broader generalized instrument to assist in the restructuring of existing manufacturing (and possibly service) activities generally, and on occasion providing assistance also for the establishment of new firms. This could be confined to Canadian controlled enterprises. If reasonably exacting standards were demanded of applicant firms, it need not be too expensive, since commercial lenders would be providing most of the funds. While such a programme might exclude some worthy foreign controlled firms, it is not expected that there would be many.

If a programme of this nature were adopted, it should be consistent with the government's industrial development policy. It might overcome what seems to be one less developed area in the financial community—assistance to entrepreneurial firms, particularly those in the middle range. That would include those with needs larger than the Industrial Development Bank normally supplies (say $500,000 to $5 million), but smaller than those the Canada Development Corporation might normally be expected to assist. While basing itself largely on insured loans, it would also have the right to loan or invest in equity. The latter option is particularly important for two reasons: some firms will not be able to carry the burden of regular interest payments in the period following receipt of a loan; secondly, the government should have the right to invest in equity where risk is particularly high.

INDUSTRIAL DEVELOPMENT BANK (IDB)

The Industrial Development Bank was established in 1944 to encourage industrial development by providing capital assistance to sound business enterprises in Canada, particularly those of smaller size, which were unable for various reasons to obtain financing elsewhere on reasonable terms and conditions. Parliament directed the IDB to be self-supporting. It is obliged by the Act to satisfy itself, that credit or other financial resources would not otherwise be available on reasonable terms and conditions to the applicant enterprise and that the amount invested or to be invested in the enterprise by persons other than the IDB, and the character of that investment, are such as to afford the Bank reasonable protection. The Act stipulates that lending is to be to enterprises which may reasonably be expected to prove successful.

Within these legislative constraints, the IDB has loaned approximately $1.4 billion to some 20,800 small and medium-sized businesses since its inception. Over the years, the IDB's powers and operations have been expanded in several ways. Its lending ceiling has been increased and at the end of fiscal 1970 was about $750 million. While the Bank's operations in its earlier days were confined mainly to manufacturing firms, its powers have been extended to permit it to lend to virtually any type of business activity. Beginning with four offices in four major cities, its services have been made progressively more directly available to the public. The IDB

now has 32 branches and two sub-branches across the country under the direction of five regional offices. The decisions on more than 95 per cent of loan applications are now made at the regional or branch level.

The IDB also has authority to guarantee loans and to make equity investments. In practice, it has made very little use of these powers.

In 1970, 3,584 loans were made by the IDB, totalling $164.6 million. Of these, by value, over 93 per cent were for amounts of $100,000 and less. Almost 50 per cent were for $25,000 and less. The average size of loan was $46,000. However, the IDB does make some loans for more than $1 million.

At the end of fiscal 1970, the Industrial Development Bank had over $555 million in loans and investments outstanding to 12,283 clients.

The percentages of loan approvals by type of business between 1968 and 1970 is shown in Table 56.

TABLE 56

IDB LOANS BY CATEGORY, 1967–70

(percentages)

	Fiscal 1967		Fiscal 1968		Fiscal 1969		Fiscal 1970
	No.	Amount	No.	Amount	No.	Amount	No.
Manufacturing	32	36	29	33	27	34	23
Transportation and Storage	5	12	4	5	3	5	4
Construction	6	4	6	5	6	5	5
Agriculture	8	6	8	7	6	5	7
Wholesale and Retail Trade	23	19	23	18	24	18	24
Tourist Industry	13	11	14	15	18	19	18
Other	13	12	16	17	16	14	19
	100	100	100	100	100	100	100

According to IDB, only a very small proportion of these loans go to foreign controlled firms.

From the above, it is apparent that the IDB is now a large lender and that it plays an important role in the financing of small and medium-sized Canadian enterprises. In doing this, it appears to have spread itself across a very wide range of business activity.

In this sense, its commitment to the entrepreneurial and development activities, which are of concern in the context of this study, is comparatively limited. Although statistics are not available, one area in which IDB activity has apparently been comparatively small is the financing of potentially profitable but relatively high-risk new manufacturing ventures. Examples would be ventures in the manufacturing and marketing of new and relatively untried products, particularly where growth in demand for the product is stimulated by its availability (again in contrast to GAAP).

From the viewpoint of protecting and advancing Canada's international competitive position, Canada's main concern is the manufacturing sector. IDB directs about one quarter of its loans to that sector. The other categories of business to which IDB lends money are normally not in competition with foreigners to the same extent as is manufacturing, although obviously foreign competition is a factor in some cases in the field of agriculture, transportation and tourism. It is similarly of interest in this context that the two sectors of highest foreign control—natural resources and manufacturing—seem to receive less than half the loans.

At present, almost all IDB loans are given to Canadian controlled firms, although this outcome is not the result of any deliberate policy. Consideration might be given to restricting IDB assistance to Canadian controlled firms alone.

Consideration could also be given to the advisability of having the IDB play a more active role in filling the gap for venture capital (perhaps up to a maximum of around $1 million) by an amendment to the IDB Act or directive to its management. This would imply an aggressive attitude by the IDB in seeking out certain kinds of investments. Such an approach need not prejudice its other lending activities.

Alternatively, consideration could be given to the advisability of separating that portion of the IDB's activities dealing with manufacturing and rationalize it with the kind of GAAP programme discussed above. The objective would be to provide a single instrument for assisting small and medium-sized Canadian controlled firms to start up, rationalize and expand—subject always to a fairly tough-minded look at applicants, especially from the viewpoint of management capability.

CONCLUSIONS

Foreign controlled firms receive a large proportion of the grants under special purpose programmes in respect of regional development, research and product innovation and the defence industries. In general, the government has been prepared to expand the value of grants available in each of these programmes as it became clear that there were applicants willing to participate in them. This suggests that, for the most part, foreign controlled firms have not been obtaining grants which would have otherwise gone to Canadian controlled firms. If one were to make foreign controlled firms ineligible for these grants, the objectives these programmes are intended to meet would be less well satisfied. However, consideration could be given to the advisability of having the review agency informed of all government grants and loans to foreign controlled firms. In addition, when grants are awarded to foreign controlled firms in the context of any programme, consideration might be given to having the department concerned—in consultation with a review agency and other immediately interested departments—determine whether the occasion provides an opportunity for bargaining for performance under-

takings, such as the removal of restrictions on exports or increasing procurement in Canada. This could be reflected in a general guidline to departments, but could not be set out in precise formalized rules because circumstances will vary sharply from one case to another.

Finally, GAAP and IDB, either rationalized into a single government industrial development agency or remaining separate, could be given part of the task of filling the need for venture capital and expansion capital. This would involve a new role for the IDB in respect of venture capital and a general mandate for the GAAP to work actively at restructuring and upgrading medium-sized Canadian controlled firms, within the framework of government industrial development policy.

TAX POLICY

A further technique which might be used to achieve the aims of policies considered in this study is that of tax incentives.

The two issues to be considered in this context are, firstly, whether the tax system should be used to increase Canadian ownership and control and, secondly, whether the tax system should be used to increase the net benefits available from foreign direct investment.

TAX BIAS FOR CANADIAN CONTROLLED FIRMS OR CANADIAN INVESTMENT

The tax system could be used to increase Canadian ownership and control in two ways. Profits earned by Canadian controlled firms could be taxed at a lower rate than profits of foreign controlled firms. Profits earned by foreign controlled firms having significant Canadian ownership, or which have entered into a venture with a Canadian partner, could also be taxed at a lower rate. Alternatively, Canadians could be accorded more favourable tax treatment on Canadian investment income than that accorded to foreigners on the same kind of income. Another and less direct technique involves according more favourable tax treatment to Canadian residents on income from investments in Canada than they would incur on foreign income. This would encourage Canadian savings to remain in Canada, thus increasing the funds available for Canadian enterprise and increase the capacities of Canada's capital markets and entrepreneurs to meet Canadian investment needs.

The previous tax system and the new tax legislation provide some preferences. Several provisions are of particular interest.

Under the old law, Canadians were not liable for tax on capital gains, although a taxpayer resident in the United States would have paid tax in his own country on capital gains made on assets in Canada; a dividend tax credit was granted on dividends from Canadian corporations (without regard to the

location of control of that corporation); the first $35,000 of taxable income of all corporations was taxed at a lower rate (regardless of control and of total taxable income); and withholding taxes on investment income paid to non-residents was five per cent lower for corporations having a degree of Canadian ownership. In addition, the income of pension funds from foreign sources could not exceed ten per cent of its income to maintain its tax-free status.

The introduction of a capital gains tax as part of the recent reform of taxation necessarily removes one form of encouragement of investment in Canada. Several other provisions, however, continue to favour Canadian investment and Canadian controlled firms, although on a somewhat different basis. The dividend tax credit on dividends paid by Canadian corporations remains in effect (still without regard to the location of control); the small business incentive is retained, but available only to Canadian controlled private corporations and must be repaid if the firm is transferred to non-Canadian control, thus directly favouring Canadian controlled corporations; withholding taxes on investment income paid to non-residents continues to be five per cent lower for corporations having a degree of Canadian ownership; and pension funds must retain ninety per cent of their *assets* in Canada to avoid paying a special tax of one per cent per month, thus providing a greater incentive to these institutions to use their very large volume of Canadian savings to meet Canadian investment needs (again regardless of the location of control, but hopefully to the benefit of Canadian controlled business). In addition, Canadian corporations are able to deduct as an expense the interest paid on funds borrowed to finance the purchase of shares in other corporations (a capacity which United States corporations have had under United States law for some years). Federal estate taxes have also been eliminated, thus potentially reducing the pressure alleged to have existed in the past to sell private Canadian corporations—often to foreign interests—in order to raise funds for payment of these taxes (although capital gains taxes are now payable on death).

The small business incentive favours Canadian controlled firms and the interest deductibility on funds borrowed for the purchase of shares also encourages the maintenance of Canadian control. The retention of the five per cent withholding tax differential may tend to favour some minority Canadian ownership. The remaining provisions concentrate on encouraging the retention of Canadian savings in Canada.

To some extent, tax incentives favouring domestic investment may be necessary or desirable to offset other tax factors which provide a bias in favour of investment abroad. For example, foreign mutual funds may provide a vehicle by which a resident investor is able to: postpone tax (by arranging to have income accumulate abroad); avoid or reduce tax (by arranging for the income to be received as a capital gains); and evade tax (by the relative ease in which the income can be hidden).

In the same way, a fiscal incentive which favours Canadian controlled firms may be necessary to offset tax advantages enjoyed by foreign producers with whom they must compete in both the domestic and international markets.

To the extent that incentives for domestic investment or domestic companies offset other foreign tax factors, they can be justified on grounds of fiscal neutrality. However, incentives which go beyond this objective are, by their very nature, economically arbitrary. To that extent, they can be justified only on grounds other than those of tax policies as such. Incentives which are arbitrary in this sense not only tend to distort investment decisions, but also can involve a significant loss of government revenues. In addition, to the extent that an incentive for one person implies discrimination against another, it invites retaliation of one form or another, from foreign governments—a fact which could neutralize its intended impact.

If foreign controlled firms are able, by virtue of their market strength, to pass on higher taxes they are required to pay to the Canadian consumer, then the objective of imposing a higher tax burden on such firms may not be achieved. Furthermore, foreign investment can have several advantages, and these ought not to be the objective of Canadian policy to deny these to Canada. Also, different circumstances demand different treatment of foreign investment. A general tax bias would not permit these considerations to be taken into account.

It was observed earlier that total Canadian savings may be adequate to satisfy Canadian investment needs. Nevertheless a significant two-way flow of investment occurs between Canada and other countries. It is possible to use the tax system to provide various incentives aimed at retaining a greater proportion of Canadian savings in Canada in order to displace foreign investment and strengthen the capacity of Canadian financial markets to support Canadian business—particularly Canadian controlled business, which is most directly dependent on Canadian financial resources and institutions.

The essential question at issue here is whether it would be appropriate to structure the tax system so that Canadian savings would be prevented or discouraged from leaving the country for portfolio investment abroad, for example, by taxing Canadian residents less on earnings drawn from Canadian investments than on earnings drawn from investments made outside Canada. As noted previously, both the former and new tax systems provide some incentives for domestic investment, particularly with regard to pensions funds.

Despite the present incentives, however, it is clear that Canadian individuals and institutions will continue to invest abroad to some extent.

In principle, it would probably be unwise to make too much greater use of tax incentives in favour of investment in Canada. Firstly, the individual investor can often find an investment which he believes to be more suitable to his needs outside of Canada than he can here. Secondly, it may be a less efficient use of resources to force Canadian investors to invest in Canada than in more attractive investments abroad. The financial return to Canada may, in fact, be greater over the long haul if Canadians are free to invest

wherever it is more advantageous for them. Thirdly, if money is retained in Canada to a degree well beyond what is needed, this could drive down interest rates, which could allow firms to borrow at a substantially cheaper rate than the international market provides. While such a development is perhaps attractive in some respects, this might allow some Canadian firms which are relatively inefficient to stay in business as a result solely of the availability of artificially cheaper capital. That is, it would have a kind of protectionist impact. In addition, if foreign capital continues to enter for reasons independent of the tax system, pressure will build on Canadian exchange rates.

Furthermore, holding Canadian savings in Canada through tax measures would not necessarily displace foreign direct investment (and perhaps not even much portfolio investment) if financial intermediaries failed to allocate the additional savings retained to domestic industries or uses to which foreign investment has previously been directed. This failure could occur as a result of the preferences of the investors or of the financial institutions. In the case of direct investment which enters from abroad, it may be tied to other valuable inputs, such as technology. The investor may not wish to sever the package, so the capital will come in any case or, alternatively, the financial resources retained in Canada will be used by foreign controlled firms.

The reasons Canadians make portfolio investments abroad can, in principle, be related to one of only two factors. Firstly, Canadian industry may generally be less efficient than foreign industry and, therefore, the rate of return on investment in Canadian industry is lower. If that is the case, it is obvious that the appropriate solution is not to force Canadian savers to retain their funds in Canada, but to take measures to help improve the efficiency of Canadian industry. Secondly, the propensity to invest abroad could reflect the inadequacies of Canadian institutions, especially those related to the operation of the capital markets. For example, some mutual funds claim that the relative lack of liquidity in Canadian capital markets and the higher transaction fees tend to lead them to invest abroad. It is also contended that Canadian investment opportunities do not include securities in several attractive industries because virtually all the companies within such industries in Canada are wholly foreign owned.

Notwithstanding these theoretical considerations, it must be recognized that any general policies that are adopted which aim at improving the efficiency of domestic industry or removing institutional problems in the capital markets take some time to show results. In the interval, it is not inappropriate to consider the provision of modest incentives to help ensure that a sufficient volume of Canadian savings are available for investment in Canada. The fact that an individual investor may get a somewhat higher return from investing abroad does not mean that it is in the overall economic interest of Canada to tolerate an unlimited outflow of such investment funds. That is, the moderate degree of encouragement provided by the tax system for Canadian savings to

be invested in Canada seems consistent with the need to increase Canadian control of Canadian business and to facilitate domestic control of the national economic environment.

Retaining Canadian savings in Canada would make more funds available for all local enterprise, regardless of its ownership or control. However, Canadian controlled business would likely benefit most by virtue of its relatively greater dependence on Canadian capital. Secondly, Canadian financial institutions, under the pressures developed by the retained savings seeking investment opportunities, might improve their capabilities even more rapidly than they have in the past. The improvement of Canadian capital markets would provide further support for the development of domestic entrepreneurship. Thirdly, the bias created by the tax system would presumably help to offset either a lower return on investment in Canadian investment than that available abroad or institutional imperfections in the capital markets. Lastly, some reduction in the relatively very large flow of funds in and out of Canada would moderately reduce the need for Canadian monetary policy to be geared to meeting changing international financial conditions and make it possible for it to be directed slightly more towards meeting the internal requirements of the domestic economy.

The above comments apply particularly to the outflow of portfolio capital. Outflows of direct investment raise different issues. In the light of some of the benefits that accrue to the investor of foreign direct investment in Canada, which were described earlier, there would seem to be no reason actively to discourage such outflows of direct investment from Canada so long as the danger of truncation is recognized.

Virtually all portfolio investment going abroad from Canada at present is made either by individuals, pension funds or mutual funds. As already stated, the new tax law will limit outflows through pension funds. As mutual funds are essentially an extension of the individual investor, it would be somewhat impractical to consider imposing limits upon their portfolio investments abroad without similar limitations on individuals. However, firm quantitative limitations would probably be considered to constitute an undue limitation upon the freedom of the individual. The question then is whether the tax incentive for the individual to invest in Canada is sufficiently strong. While the study suggested earlier that consideration be given to a number of measures aimed at improving capital markets, it does not argue generally in favour of a strong tax incentives over the long run to encourage Canadians to invest in Canada.

USE OF TAXATION TO INCREASE THE BENEFITS FROM FOREIGN INVESTMENT

The tax system could be employed as a means of securing increased benefits from foreign direct investment. Tax incentives could be provided, for example, to encourage particular activities, such as increased exports or R&D.

However, it would not seem logical to offer these incentives solely to foreign controlled firms to induce them to improve their performance, with the result that it would be necessary for them to be offered generally to all Canadian taxpayers. The principal disadvantage of this approach is that it is arbitrary and inflexible. Furthermore, the incentive is available to firms which normally undertake the activity involved without any special inducement, with the result that such an approach can be costly in relation to the net benefits received.

An additional method of drawing benefits from foreign investment is to tax it more heavily than Canadian investment. This would not only favour Canadian controlled firms, but also increase the revenues to Canada from such investment. Again this is arbitrary if applied across the board and fails to take account of the widely different costs and benefits of foreign investment in different industries and situations.

CONCLUSIONS

For some of the reasons already touched on and for others discussed below, it does not appear to be feasible to consider making any substantial changes in the existing tax system as a further means of achieving increased control of the domestic economy or the performance objectives outlined in the study.

In the first place, it is difficult to gain acceptance internationally for a discriminatory tax policy.

Secondly, tax measures are not readily differentiated by individual industries—nor on a company-by-company basis. If it were concluded that tax incentives could play a useful role, it might be necessary to consider making them available on a selective basis. The less selective a tax preference is in its application, the more arbitrary it becomes in economic terms and the more costly to the economy as a whole. A widely available tax preference aimed at encouraging a company or individuals to follow a certain course, for example, provides an unnecessary financial benefit to those who would pursue this course regardless of any special inducement for good and sufficient reasons of their own.

Thirdly the tax advantage or penalty approach can be offset by tax provisions in foreign jurisdictions. A foreign firm paying a Canadian tax penalty or gaining a Canadian tax preference may neither suffer nor benefit if the effect is simply to alter the taxes payable to his own government by an equal amount.

Lastly, in industries where foreign ownership is high and market power is significant, any added tax cost might be passed on to the Canadian consumer or user.

There is the further question of how far the tax system should go in providing a tax advantage in favour of the Canadian investment of domestic savings, either to compensate for the deficiencies or biases of the financial institutions, or of off-setting lower returns from Canadian, as opposed to

foreign investment. It is not easy to justify the use of tax policy to overcome either of these deficiencies—particularly when the tax approach would tend to hold Canadian savings in Canada regardless of the industrial application to which they might be directed.

While tax policy should not be to the disadvantage of the Canadian controlled firm, nor discourage the holding of savings in Canada, it would not seem to be appropriate as a major instrument for a strong bias in favour of either of these policy purposes.

Chapter Twenty Two

THE ADEQUACY OF INFORMATION

INTRODUCTION

Vast amounts of statistical and other types of information on Canadian corporations, both resident and foreign controlled, are collected by various government departments and agencies.[53] This information covers practically all aspects of company financial and other operations—statements of income and expenditure, source and use of funds, surplus, investment and investment intentions, ownership, production, employment, international trade, sales, profits, research and development, wages and salaries, value added and management (directors and senior officers).

Qualitative or non-statistical information useful for policy purposes (e.g., about marketing policies, licensing arrangements, R&D policies and the organization, structure, and functioning of companies) is collected by Statistics Canada and the Departments of Finance; Industry, Trade and Commerce; Energy, Mines and Resources; and Consumer and Corporate Affairs in connection with various departmental programmes.

Although this plethora of information is collected by departments and agencies of the federal government, most of it may be avalable to the public and/or government policy makers in aggregate form only. For example, the *Statistics Act*, the *Income Tax Act*, and, to some extent, the *Corporations and Labour Unions Returns Act* (CALURA), preclude the divulgence of individual company information for purposes other than those for which it was collected.

The adequacy of information available on the corporate sector can only be judged in relation to the purposes of the potential users. Because the number of potential users and the purposes to be served are so numerous and so diverse, no general answer to the question of adequacy can be given. What is adequate for private investment analysis may not be

[53] These collectors of statistical information include Statistics Canada; the Bank of Canada; the Departments of Industry, Trade and Commerce; National Revenue (for taxation purposes); Consumer and Corporate Affairs (returns under the Canada Corporations Act); and a number of regulatory bodies.

adequate for the government policy maker; what is adequate (in aggregate terms) for the Bank of Canada may be adequate (in sectoral terms) for the Department of Industry, Trade and Commerce.

This chapter is concerned with an examination of four broad purposes for which corporate information is required in order to achieve better control of the domestic economic environment:

(i) the identification of the degree of foreign ownership and control in the Canadian economy in general and in particular industrial sectors, and changes in the pattern of foreign ownership and control over time;

(ii) economic analysis as a basis for policy formulation including the costs and benefits of foreign direct investment in relation to important economic variables, such as technology, employment, capital, tax revenues, etc., and the comparison of the performance of foreign controlled and Canadian controlled firms in relation to such items as identified in the guidelines programme of the Department of Industry, Trade and Commerce;

(iii) the possible implementation of a review procedure for foreign direct investment; and

(iv) the improvement of resource allocation and of the efficiency and depth of capital markets through better disclosure (e.g., profit opportunities by product line) to allow Canadian entrepreneurs and portfolio investors to make more informed judgments on the investment of their capital, which could affect foreign control in two ways, (a) by helping to keep savings in Canada that might otherwise be invested in the United States, and (b) by increasing awareness of profit opportunities, especially in those sectors dominated by foreign controlled firms.

No hard and fast lines can be drawn between the types of information needed by government for various purposes. Information on a particular variable—such as profits by product line—may be required for purposes of economic analysis, the review of a particular investment, or the efficient allocation of capital between competing claims. Information on changes in the ownership and composition of investments in Canada, for example, a shift from equity to debt, with foreign controlled companies relying more on Canadian capital markets, could be used for the identification of changes in control, for economic analysis, or for the determination of whether a foreign investor going through a review process should be required to bring a certain amount of capital with him. In general, it can be said that for purposes of identifying control or undertaking a review it is necessary to have access to data on an individual company basis, whereas data for purposes of economic analysis are normally aggregated.

THE IDENTIFICATION OF FOREIGN OWNED AND CONTROLLED COMPANIES

Important to all four purposes to be served by information outlined above is the identification of those companies that are foreign controlled and the changes in the degree of foreign control over time. This information is a key to the implementation of policies on foreign control of the domestic economic environment.

Control of a corporation is normally exercised through the ownership of over fifty per cent of its voting stock. However, effective control can be exercised in other ways:

(i) by a minority holding of voting rights if the ownership of the voting stock is widely diffused;

(ii) by the ownership of corporate debt;

(iii) by purchase or supply contracts;

(iv) through licensing arrangements and franchises;

(v) through management contracts or informal understandings with management; and

(vi) through voting trusts, shareholder agreements, or other contractual arrangements, including the potential for obtaining control through securities, pledged agreements, or trust indentures in cases of default.

Both CALURA and the International Investment Position (IIP) compiled in the Balance of Payments Section of Statistics Canada collect information on the ownership of voting rights. However, the concept of control used in these cases is slightly different. In the CALURA series, a company is considered to be foreign controlled if fifty per cent or more of its voting stock is known to be held outside Canada, or by one or more Canadian companies which are, in turn, foreign controlled. IIP statistics as a general rule record an enterprise as foreign controlled only if fifty per cent or more of its voting stock is beneficially owned *in one country* outside Canada. The enterprise includes all the corporations over which the foreign parent company or group of shareholders are in a position to exercise control. For the Industry, Trade and Commerce guidelines programme, a Canadian company is regarded as foreign controlled if fifty per cent of its voting stock is owned by one foreign parent.

Minority holdings present problems in classifying a company by country of control. The statistical concept of foreign control through ownership of voting stock is occasionally modified in IIP statistics to include enterprises where it is believed that effective control is held with less than fifty per cent

of the voting stock. However, no detail and systematic analysis of minority holdings is undertaken. This practice is not followed by CALURA. Neither the CALURA nor the IIP series takes account of control which may be exercised through means other than the ownership of voting stock, such as licensing and franchise agreements and monopolistic marketing arrangements.

Judgments on who controls a particular Canadian company made in connection with the IIP programme are not available to the public or government policy makers because of the confidentiality provisions of the *Statistics Act*. Judgments on control used in the CALURA series are also, in a few cases, not available to the public or government policy makers because some use is made of confidential IIP data to supplement information provided under CALURA.

The geographic allocation of foreign control also differs somewhat between the two series. In CALURA, control of the Canadian company is attributed to the foreign country where the majority of the corporation's voting rights is actually *held,* while in the IIP control is, as far as possible, ascribed to the country where the majority is beneficially *owned.*

The problem of nominee holdings in Canada could be solved by requiring banks and trust companies to divulge the identity of nominees, as was done during World War II. However, it can be expected that these institutions would resist this step. Nominee relationships can, of course, take a variety of other forms and not all nominees are resident in Canada.[54]

While there are differences between the IIP and CALURA concepts of control—with the former tracing majority holdings to *one* country, identifying minority holdings where possible, and seeking to identify the ultimate beneficial owner—it should be remembered that the general criterion of control (ownership of fifty per cent or more of voting stock) is the same in both cases. The differences do not appear to create significant variations in the statistical aggregates, but they are obviously important for a few companies, notably for some in the mining industry.

In both the CALURA and IIP series covering control, as distinct from ownership, the whole of the corporation or enterprise (whether measured in such terms as Canadian book value, total assets, sales, profits or equity) is assigned to one or other country of control.

It should be noted that while CALURA publishes some statistical series by country of control, its annual reports did not focus on the presentation of *control* statistics prior to that for 1969. The main emphasis has been on presenting corporations classified by degree of non-resident *ownership.*

In addition to the differences in the concept of control used in CALURA and IIP, it should also be noted that a number of companies in which there may be foreign investment or which may have foreign transactions are exempted from reporting under CALURA. Not covered by the Act are:

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[54] The concept of control through ownership would also require consideration of the role of foundations.

(i) small companies having annual gross revenue of $500,000 or less and assets of $250,000 or less (Consideration could be given to granting authority to survey periodically corporations excluded by this criterion);

(ii) companies already falling under various governmental regulatory agencies, such as broadcasting, transport companies and banks (Consideration could be given to inclusion, as required, of such relevant information as is now reported to the agencies. However, as reporting requirements may not be fully comparable, it may be necessary to obtain additional information from these companies. Some efforts are now being made by Statistics Canada to fill these gaps);

(iii) government business enterprises (Consideration could be given to requiring those enterprises to provide CALURA-type information. This information would be useful as a "yardstick" in trying to assess the performance of foreign controlled companies in the industries concerned);

(iv) unincorporated branches in Canada of foreign corporations which are exempt from reporting payments to non-residents (However, information on ownership and other financial operations is required);

(v) individual resident shareholders who are excluded from the question dealing with intercorporate links. (The request for the names and addresses of *each corporation* holding ten per cent or more of total issued shares could be rephrased to include *persons* resident in Canada).[55]

Although the concept of control used in CALURA is, for all intents and purposes, the same as that employed in statistics for the IIP, it is important to note differences in the use of the term "ownership". It is recognized that the two measures of ownership are designed to show different aspects of foreign activity and, to some extent, complement each other.

IIP Measure

In many Canadian concerns (regardless of whether they are foreign controlled or not), there is some foreign investment. This investment may take the form of foreign ownership of the corporation's bonds, debentures, or other debts—or it may represent a foreign bank loan, or investment in its common or preferred stock. The IIP measure of foreign ownership covers long-term investment of this sort (in terms of book value rather than market

[55] Persons with an address outside of Canada or no address of record and holding five per cent or more of the total issued shares of any class report under CALURA.

value). Aggregate figures on the value of investments in an industry designated as foreign owned and the value of those designated as foreign controlled may differ significantly, depending upon the mix and structure of the enterprises included.

CALURA Measures

The proportion of voting rights held by residents and non-residents is the criterion employed by CALURA for measuring ownership, with the whole of the corporation (whether measured in terms of assets, profits, sales or whatever) being classified as falling into one of several categories according to the degree of non-resident ownership as determined by this criterion.

INFORMATION FOR ECONOMIC ANALYSIS

Since foreign direct investment involves both costs and benefits, the government should be in a position to assess the net impact of this investment on the Canadian economy. The determination of net benefit requires data on contributions to tax revenues, net balance of payments, employment, net value added, the development of technology, sources and uses of funds, the volume, timing and variability of international capital transactions, and so on. This includes data similar in nature to that requested from foreign subsidiaries reporting under the guidelines programme of the Department of Industry, Trade and Commerce. This approach also requires an ability to compare the performance of the Canadian controlled and foreign controlled segments of an industry, to the extent that is possible, on the basis of "matched pairs". It is also important to be able to compare the performance of Canadian subsidiaries with similar subsidiaries in other countries.[56] Neither of these comparisons can be made at present with the existing published data.

For purposes of economic analysis, it is not necessary to have access to individual company information (except perhaps to explain peculiar movements in the aggregate); in general, aggregate data are sufficient.

Statistics Canada now collects extensive information on all companies in Canada, including those that are foreign controlled. This includes statistics on international capital flows, sales, profits, retained earnings, tax payments, production, employment and payrolls, research and development, and payments to non-residents.

[56] It is worth noting that a request to Canadian subsidiaries to provide data on the operations of affiliated foreign subsidiaries would constitute a form of extraterritoriality. Since this information would, in most cases, not be available to the Canadian subsidiary, it would be very difficult to obtain. (It should be noted, however, that the U.S. Government gets large quantities of information on the operation of Canadian subsidiaries from U.S. parent companies.) An alternative would be to seek international cooperation (perhaps through the OECD) in the exchange of such data in aggregated form.

A major contribution could be made to the understanding of the part played by the foreign controlled company in Canada if Statistics Canada data on company operations could be sub-divided between Canadian controlled and foreign controlled companies. A serious obstacle arises from the fact statistics collected under CALURA are, by law, required to be on a company basis, the census of industry and other operational statistics are on an establishment basis, and IIP data are on an enterprise basis. Statistics Canada is at present seeking to coordinate and integrate the data on these three levels. A further complication is that the CALURA data are required by law on a financial-year basis, whereas Statistics Canada balance of payments data are generally on a calendar-year basis. IIP data are on a financial year from April 1 to March 31.

Among the major gaps in Statistics Canada data available for economic analysis, some of which create severe difficulties in trying to reach policy conclusions, are the following:

(i) Some important statistics are not collected at present or available on the basis of resident/non-resident control or transactions by country. These include merchandise exports and imports by company. This partly prevents the identification of net contribution to balance of payments by industry sub-divided between the Canadian and the foreign controlled sectors. In certain circumstances, net balance of payments data by project, company or industry would be useful. Other gaps include information on:

- —production and exports by degree of processing or fabrication; total sales by product line;
- —detailed information on domestic and foreign sources of financing, including new capital issues, cost of funds, etc.;
- —purchases of merchandise, including capital equipment, materials and components, and goods for resale;
- —purchases by a foreign controlled company of goods and services from another foreign controlled company, which reflect a common relationship between parent companies abroad;
- —retained earnings. Statistics Canada information on retained earnings is quite limited, in contrast to the series on dividend payments, which is well-tabulated and reported in the balance of payments statistics;
- —payments for non-merchandise transactions. CALURA data do not show the countries involved, nor whether transactions are between affiliated companies;
- —data on technology, such as sales of goods produced under licence, purchases required under licensing arrangements, net balance of payments for R & D, licensing fees by industry and type of technology, etc.

(ii) Some data are collected but not published in the most useful form for analysis of resident/non-resident operations, including:

—comprehensive data on international transactions are collected separately for receipts and payments to affiliates and others for business services and capital flows, but are not published in detail (e.g., breaking out payments for advertising, R & D, management fees, etc.), nor are transactions between affiliated companies shown separately;

—purchases of capital equipment by industry sector.

(iii) Some data are collected and published, but only on an occasional basis, which makes the detection of trends difficult. These include:

—CALURA data on the use of Canadian directors and top managers;

—CALURA data on payments to non-residents for business services.

It should be noted that filling the gaps in some instances would involve an increased burden on Statistics Canada and in other cases on reporting companies.

For meaningful analysis, these data should not only break out the Canadian and foreign controlled sectors, but also show the country of source or destination in trade transactions and indicate those transactions that take place between affiliated companies which are relevant.

Efforts could be made to determine what material should be published annually—such as changes in the extent of control and payments to non-residents, what should be published regularly but not annually—perhaps including employment by foreign controlled companies, licensing arrangements and long-term purchase and sales contracts, and what published only occasionally —such as degree of processing, Canadian content or the position of the Canadian subsidiary in the multinational enterprise.

The multi-product company presents a particular problem with regard to the compilation of information for purposes of economic analysis. There is often difficulty in determining under which industrial classification it should be placed. This difficulty is further compounded by the fact that there is more than one system of industrial classification currently being employed. CALURA, for example, employs the Standard Industrial Classification (SIC), which provides a fairly detailed breakdown by industrial sectors. The IIP series, on the other hand, uses a derivation of an earlier classification system which designates industries according to the chief material components employed. This grouping is not as revealing or useful for purposes of economic analysis and complicates the problem of integrating IIP data with other Statistics Canada series. The Statistics Canada analysis of the balance of payments for 1963, 1964, and 1965 did contain a series of tables on the degree of foreign control by industry using the twenty SIC industry groupings

for manufacturing establishment data. This type of analysis should be undertaken more frequently, perhaps on a regular basis. The problem of determining the industrial classification of a particular reporting unit is even more difficult in the case of the IIP data because they are compiled on the basis of enterprises, which may include a number of associated companies.

CALURA assets information aggregates the data for individual companies (including investments in their own affiliates in Canada and abroad). IIP data are on an enterprise basis and are, in addition, adjusted to eliminate Canadian investment abroad. In CALURA analysis, therefore, corporations such as the Aluminium Company of Canada and the International Nickel Company of Canada, both of which have large investments outside Canada, loom disproportionately large in their respective sectors when viewed in relation to their actual operations in Canada.

Some of these gaps are filled by the Department of Industry, Trade and Commerce publication, "Foreign Owned Subsidiaries in Canada", which contains useful information on transactions between Canadian companies and their affiliates abroad—including exports and imports. However:

(i) It includes only 333 foreign owned enterprises covering 972 companies.

(ii) The information is collected on a voluntary basis and there is no requirement for a company to cooperate with the programme.

(iii) There is no Canadian controlled group against which the performance of the foreign controlled companies may be systematically assessed.

(iv) Some revisions in the type of information collected would be useful. For example, more information on assets is required; there should be some measure of the degree of processing; purchases from parents and affiliates should be designated according to their home country and not simply classified as being made in the United States or "other" foreign countries. Greater detail on the procurement of services would be desirable.[57]

The three major sources of information on foreign controlled companies all have their shortcomings. In the circumstances, it would seem sensible to consider whether it would be desirable to concentrate on making one source more adequate, rather than trying to amend and improve all three, by developing a single, conceptually integrated statistical system covering all statistical series relevant to foreign control. Consideration could be given to whether the most promising means of attaining this objective may be to use Statistics Canada's general statistics gathering authority. This would involve

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[57] Appendix A contains a fuller discussion of the nature, coverage, comparability and problems of the data collected from the companies reporting to the Department of Industry, Trade and Commerce under the guidelines programme.

terminating the Industry, Trade and Commerce statistical programme and repealing Section B[58] of Part I of CALURA.[59] This would permit the Chief Statistician to provide more comprehensive and meaningful statistics on foreign controlled companies by integrating and expanding his current programme, a step which is now impeded by the inflexibility of CALURA. The Act, as indicated above, specifies the precise content and wording to be used in survey questionnaires, their coverage, fiscal periods to be covered, etc. Because any changes in CALURA require an Act of Parliament, the task of integrating Statistics Canada data is made even more difficult. This form of consolidation would eliminate the need for three separate requests for financial and other types of operational information from the business community for the purposes of the IIP, CALURA and the guidelines programme of the Department of Industry, Trade and Commerce.

Even if it were decided to repeal Part B of CALURA, Section A—under which such information as share ownership and residence of directors, is collected—should probably continue to apply because at the moment it is the only source of information on the ownership of particular companies available to the general public. Consideration should be given, however, to expanding the legislative authority under that section to cover all companies, perhaps providing that they should report through the ultimate holding company to eliminate the duplication that now occurs. It could be the basic building block for a register of foreign controlled companies in Canada.

A further possibility would be to amend the *Statistics Act* as it applies to corporations to allow the publication of data for individual companies, such as that now collected under Section A[60] of CALURA.

The concentration of resources in a single group within Statistics Canada to assemble all the relevant foreign investment statistics appears to merit consideration.

INFORMATION REQUIRED FOR A REVIEW PROCESS

Information for the two purposes discussed thus far is required, no matter what the scope of foreign investment policy may be, simply to enable the government and the public to know what is going on. In addition, if a policy of reviewing foreign investment is adopted, the review authorities would require powers to obtain additional information on the operations of *individual* companies to carry out their function.

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[58] This section provides for the confidential portion of corporation returns, including financial statements of the corporation and a schedule of selected payments to non-residents for dividends, interest and certain business services.

[59] Another alternative, turning CALURA into a general disclosure statute, is discussed below.

[60] This section provides for the non-confidential portion of corporation returns, including information on the incorporation, officers and directors, and ownership of the corporation's issued share capital.

In general, the authorities monitoring foreign direct investment would require information to enable them to undertake cost-benefit analyses in the widest sense. The specific items of information required would depend upon what investment the government decides to review and what factors may be made subject to negotiation.

Information available on takeovers at present is very limited. Returns under CALURA provide information on changes in the nationality of ownership, but there is considerable lag in the availability of information from this source. The revised *Canada Corporations Act* will go only part way toward remedying this situation. The takeover provisions in the Act are designed to protect investors and not to provide information of the sort required by a review agency. Section 127 (B) requires that a copy of all takeover bids, along with any supporting material, must be sent to the Department of Consumer and Corporate Affairs. A takeover bid is defined as an offer to shareholders of a public company with fifteen or more shareholders to purchase sufficient equity shares to acquire—together with any already owned—more than ten per cent of the outstanding equity of the company. This provision covers only publicy-owned companies that are federally incorporated; it excludes purchases by way of private agreement, private companies, and provincially incorporated companies. A policy to review takeovers effectively would have to go beyond the provisions of the *Canada Corporations Act* and require all those seeking to take over companies of a certain defined significance to disclose their intentions to a review agency.

Information on future capital investment intentions is at present collected through the "Survey of Public and Private Investment Intentions" undertaken jointly by Statistics Canada and the Department of Industry, Trade and Commerce on the basis of a sample of both Canadian and foreign controlled companies. This information is collected under the *Statistics Act* for the purposes of economic forecasting. The Economics Branch of the Department of Industry, Trade and Commerce and the Economic Council of Canada also collect investment intentions data annually from a few hundred large firms on a voluntary basis. These surveys cover intentions over the next one, two and five years. If it were decided to review new foreign investment of major expansions of existing foreign controlled firms, legislative authority would be needed to obtain the information on proposed investment required by the review agency.

There is no information collected that relates to any of the other possible areas of investment review, such as licensing and franchise agreements and long-term purchase and supply contracts.

The review authorities would also require information on the performance and operation of a representative group of individual companies, both Canadian and foreign controlled, to put themselves in a position to bargain effectively with potential foreign investors. Since these authorities would have to be very familiar with the industry and how major com-

panies are operating within it, the companies reporting should be broadly representative of all industries likely to be of interest to foreign investors.

This would, of course, require access to individual company information of basically the same type as would be provided to Statistics Canada under the expanded programme for economic analysis put forward for consideration above. The easiest and simplest way for the screening authority to obtain this information would be from the Statistics Canada. However, this could not be done due to the secrecy provisions of the *Statistics Act*. Changing these provisions could jeopardize the overall integrity of this Act and the effective functioning of the statistical system. In these circumstances, it would seem preferable for the review agency to have separate legislative authority to require companies to provide this information directly. It is open to serious question whether the exact requirements for information should be specified in legislation itself, as is the case under CALURA, because this procedure is likely to prove too cumbersome and inflexible for the purposes it is intended to serve. Instead, the legislation could simply provide the agency with the authority to collect information required for the purposes of the Act.

It is suggested that the review agency not itself become too deeply involved in the collection and analysis of statistics. To keep this information programme within manageable proportion, it should probably be limited to "key" companies of economic significance. The Industry, Trade and Commerce guidelines programme at present collects data on 333 foreign owned enterprises. Perhaps this could be increased to about 500, including both Canadian and foreign controlled companies. Interpretation of the data would require not only extensive analysis, but also continued contact with the key companies.

Individual company data would not be published, though it might be used in aggregate form in any reports issued explaining particular decisions of the review authorities.

As pointed out above, numerous departments and agencies are repositories of information on individual industries and company performance. A review agency would probably have to rely extensively on these other departments and agencies for data, analyses, judgments and other forms of assistance. If it is decided that such an agency should obtain information under its own legislative authority and cannot use the material submitted to Statistics Canada, it would be important that there be close cooperation between the two in determining the concepts that are employed so that information collected by the agency can be integrated into the statistical system used by Statistics Canada.

The agency could also keep a record of all government assistance to foreign controlled subsidiaries, whether from federal or provincial sources. This information would be useful in assessments of the costs and benefits of a particular foreign investment.

The last type of data that would be required by a review agency is what might be called surveillance information, that is, information from the companies that have given certain undertakings to the review agency with regard to such matters as exports, procurement, research and development. It should be necessary for these companies to report periodically on their performance in fulfilling the obligations they assumed.

One of the important matters to be considered is the question of giving the minister responsible for the review agency authority to designate a particular company as foreign controlled in the absence of clear statistical data. Any judgment on control made by the minister should be conveyed to Statistics Canada for consideration of any consequent changes required in their statistical series.

FOREIGN CONTROL AND DISCLOSURE

Apart from the protection of the individual portfolio investor, public disclosure of certain corporate information can serve three broad social purposes related to the issue of domestic control of the Canadian economy. It can:

(i) facilitate protection of the public interest (since the conduct of large corporations has an effect on the well-being of many Canadians);

(ii) improve the efficiency of capital markets by permitting shareholders (including potential shareholders) to make an intelligent decision on whether to acquire, retain or sell securities; and

(iii) attract more Canadians into the market place to exploit profit opportunities identified by better disclosure.

However, Canadian disclosure requirements, federal and provincial, are not as stringent as those in the United States.

Moreover, until the recent revision of the *Canada Corporations Act,* most foreign controlled companies did not have to publish any financial statements because they were "private" companies. Very little is known about their operations and, because foreign control is highly concentrated in certain sectors, there also are important gaps in the information available.

Two results flow from this with respect to the issue of foreign control of Canadian business:

(i) There is a tendency for some Canadian portfolio investors—including institutional investors—to move into U.S. equities, which reduces the savings available in Canada and the liquidity of Canadian capital markets. Stringent SEC disclosure requirements may be a factor in this movement, serving as they do to reduce the number of unknown elements and, therefore, the degree of risk.

(ii) Better information on corporate performance and rates of return (e.g., profits by product line) might draw Canadian entrepreneurs into those areas of greatest opportunity and increase Canadian control of the economy. However, it should be recognized this information would also be available to foreign investors and could conceivably lead to increased foreign control in the absence of other government policies. Better information on investment opportunities would, however, increase competition and thereby allow Canadians to extract more of the benefits of foreign investment in Canada.

Improved aggregate data for the purposes of economic analysis (as suggested above) would also contribute to these ends, but not as efficiently and directly as the disclosure of information on the operations of individual companies.

The revised *Canada Corporations Act* will go some way towards alleviating these problems by requiring federally incorporated *private* companies of economic significance—those whose gross revenue exceeds $10 million or whose total assets exceeds $5 million—to file financial statements and auditors' reports with the Department of Consumer and Corporate Affairs. All federally incorporated public companies—regardless of size—are, of course, required to file similar information. While the Act puts private foreign controlled companies on the same footing with private Canadian controlled companies, and thus eliminates an apparent discrepancy in the available information on foreign versus Canadian controlled companies, it applies only to federally incorporated companies. The Department of Consumer and Corporate Affairs estimates that the total number of public *and* private companies which will be required to report under the revised Act will not exceed 3,000. (The total number of companies reporting under CALURA is about 50,000). Of these 3,000, about 1,800 are of economic significance, according to the definition referred to above, and of these 1,800, about 700 are private. The number of foreign controlled companies would be even smaller, since some of the 700 private companies are Canadian controlled.

It should be borne in mind that the data required under the *Canada Corporations Act* are primarily of a financial nature, i.e., a statement of source and application of funds, income statement and surplus. The required returns do not cover many items of information of economic interest, such as employment, exports and imports, receipts from and payments to non-residents and research and development.

A further possibility could be examined. This is the conversion of CALURA into a general disclosure act applying to all companies doing business in Canada above a certain size. This would involve amending Section B of CALURA to bring it more into line with the requirements of a general disclosure statute, an extension of the coverage under CALURA to include companies reporting now to other government agencies, and a repeal of some of the disclosure provisions of the *Canada Corporations Act*.

Careful consideration would have to be given to the relationship between a revised CALURA and the *Corporations Act*. For example, should information on such matters as insider trading and takeovers be covered under CALURA or the *Corporations Act?*

The information collected under Section A of CALURA would still be available to Statistics Canada and others for ownership purposes. This could probably involve different thresholds for Section A (relating to ownership) and Section B (relating to disclosure by companies of economic significance). Publication of data and analyses on the foreign controlled sector would, as suggested above, be carried on under the general statistical power of the *Statistics Act*.

The main advantage of this approach would be to extend coverage to provincially incorporated companies, which are not covered by the *Canada Corporations Act,* thus requiring the disclosure of information on individual companies whether they are federally or provincially incorporated. Of course, the disclosure provisions would apply not only to foreign controlled companies, but also to Canadian controlled companies doing business in Canada.

TIME LAG PROBLEM

There is some scope for the improvement of the timeliness with which information on foreign controlled companies is published. For example, CALURA data for 1967 were not available publicly until February 1970; the 1968 CALURA information was not published until December 1970, and details of Canada's international investment position for 1967 were not published until August 1970. However, the scope for improving the timeliness of information should not be exaggerated; in many cases it will not be possible to obtain definite information about a company within six to twelve months after the closing of the company's books for any year.

Aggregation and analysis within the collecting agency tends to take a minimum of a further six months.

CONCLUSIONS

There is an important difference between the government requesting information from a corporation and from a private individual. A corporation is an aggregation of power with indefinite life and, in most cases, limited liability. It is also a creature of the state; enjoying certain rights and having certain obligations in law. It is to be expected that its creator should wish to be kept informed about its activities, particularly when the decisions of the corporations have a widespread public impact. Firms that

help to determine the salary and work conditions of 10,000 or 20,000 people, that play a leading role in our trade, or in a particular industry, are in a very different position than individuals. Thus, what might be regarded as unjustifiable "snooping" in the case of an individual may not apply in the case of a corporation.

The various changes in the gathering of information discussed in this chapter should not raise significant new problems for corporations in terms of the disclosure of confidential information which could damage their competitive position. A change in the definition of control or improvements in the information for economic analyses would not involve public disclosure of information on individual companies, nor would the reporting programme for 500 or so companies which was suggested as necessary for the operation of an effective review mechanism. A more comprehensive public disclosure statute would, of course, require individual companies to reveal more detailed information, but it could presumably contain a clause similar to Section 1211 of the *Canada Corporations Act,* which permits a company to apply to the courts for exemption from the reporting requirements if disclosure of certain information would be "seriously and unfairly detrimental to the interests of the company". As is the case with the present *Canada Corporations Act,* there is a problem of balancing the public and private interest. In recent years, however, there has been a growing consensus that the public interest requires greater disclosure of corporate information. It should be borne in mind also that the implementation of some of the options raised in this chapter would reduce the burden of reporting which corporations have under existing information programmes.

Vast amounts of statistical and other information on Canadian corporations,—both Canadian and foreign controlled—are collected by various government departments and agencies, but some significant gaps exist either because the data are not collected, or they are collected and not published. Government policy makers do not have access to much of the data collected by Statistics Canada because of the secrecy provisions of the *Statistics Act.*

There are four broad purposes for which corporate information may be required in relation to domestic control of the national economic environment:

(i) the identification of foreign controlled companies;

(ii) the economic analysis of the costs and benefits of foreign ownership in the Canadian economy in aggregate terms;

(iii) the implementation of a review process for direct foreign investment; and

(iv) the possible increase in Canadian control of business activity, through improved disclosure (e.g., profits by product line). (This could lead to the retention of more savings in Canada and to the

attraction of more Canadians into the market place to exploit profit opportunities identified by better disclosure, especially on the part of foreign controlled companies.)

There are two main sources of information for identification of foreign controlled companies: corporate returns under the *Corporation and Labour Unions Returns Act* (CALURA) and the International Investment Position (IIP). While there are differences in the "ownership" concept used by CALURA and IIP, the concept of control used by both is broadly similar, i.e., an enterprise (IIP) or corporation (CALURA) is regarded as foreign controlled if fifty per cent or more of its voting rights is known to be held outside Canada (CALURA), in one country (IIP) or by one or more Canadian companies which are, in turn, foreign controlled. This statistical concept of control is modified in IIP to include enterprises where it is believed that effective control is held with less than fifty per cent of the voting rights. This practice is not followed in CALURA. IIP also tries to trade nominee holdings to determine beneficial ownership. It also has somewhat fuller coverage than CALURA. Thus the information on control of Canadian companies developed for IIP is somewhat more refined and comprehensive than CALURA data. However, the differences in the CALURA and IIP concepts of control are not sufficient in themselves to create significant differences in the statistical aggregates. Neither series takes account of control which may be exercised through means other than the ownership of voting rights, such as licensing and franchise agreements and monopolistic marketing arrangements. IIP presents most of its data with respect to enterprises as a whole in terms of the concept of control, whereas CALURA has tended to concentrate on degrees of foreign ownership.

Judgments on control of particular Canadian companies made by Statistics Canada are not available to the public or government policy makers because of the confidentiality provisions of the Statistics Act.

Statistics Canada collects and publishes a great many statistical series for economic analysis of the impact of corporate activity in Canada. A major contribution to the understanding of the economic impact of foreign controlled companies would be made if Statistics Canada data could be readily sub-divided between foreign and Canadian controlled companies. The solution to this problem would involve integrating enterprise, corporation and establishment statistics. Work is already underway in Statistics Canada on this difficult but important task.

There are a number of important gaps in the data available from Statistics Canada for economic analysis:

(i) Some data are not collected or made available on a basis of resident/non-resident control or transaction by country (e.g., merchandise exports and imports by company).

(ii) Some data are not published in most useful form for analysis of resident/non-resident operations (e.g., non-merchandise transactions between affiliated companies).

(iii) Some data are collected and published, but on an irregular basis (e.g., data on the extent to which Canadians serve as directors and senior managers of foreign controlled firms.

Another serious problem with Statistics Canada data for purposes of economic analysis arises from the fact that the IIP series use different reporting units and a different industrial classification than CALURA. It is thus extremely difficult to integrate fully these two series.

The data collected by the Department of Industry, Trade and Commerce under its guidelines programme fill some of these gaps, but are themselves lacking in other respects.

The information required for the implementation of a review process would depend upon what the government decides to review and what areas to make subject to negotiation. It would involve access to individual company information, but this need not be published.

To carry out its function, the review agency would require authority to obtain certain information. Consideration might be given to empowering it to:

(i) require foreign controlled companies subject to the review procedure to submit required information on the basis of which to make a decision on whether to allow the investment to go ahead;

(ii) obtain access to information on the operations and performance of a representative group of companies (both Canadian and foreign controlled) to provide the basic data necessary to enable the review authorities to negotiate effectively (This information should be collected from about 500 companies and should be conceptually compatible with that provided to Statistics Canada. The review authorities would have to work closely with other departments and agencies which also have accumulated large amounts of information and expertise on various industries and companies); and

(iii) maintain surveillance of the manner in which companies fulfill any undertaking given to the review agency.

POSSIBLE MEASURES TO IMPROVE INFORMATION ABOUT FOREIGN DIRECT INVESTMENT

A number of steps could be contemplated in an effort to improve the quality of information that is relevant to various aspects of foreign direct investment in Canada. These could involve considerable changes in the existing system of collecting and aggregating data, which could only be implemented in phases over an extended period of time. Some indication of the kinf of measures that might be considered are outlined under four major headings.

(i) The statistical definition of control might be standardized, perhaps developing a definition along the lines used by Statistics Canada for IIP statistics. Ownership statistics should continue to be published using *both* ownership concepts, since each is useful for different purposes.

(ii) More resources could be devoted to the problem of identifying effective control of Canadian companies, which may manifest itself in other ways than majority ownership of a company's voting rights. The responsibility for this should rest with the minister to whom the review authorities report. Statistics Canada should be informed of these decisions in order to consider whether changes are required in their statistical series. The review agency could maintain a register of foreign controlled companies to which the public has access. A list of changes in control could be published monthly in *The Canada Gazette*.

(iii) Legislative authority might be given to either Statistics Canada or the review agency—or both—to require banks, trust companies or other nominees to divulge the owners of nominee accounts if such information were required for the purpose of identifying foreign control.

ECONOMIC ANALYSIS

(i) Rather than operating three major statistical programmes which relate (at least in part) to foreign controlled companies, the government could consider concentrating on the improvement of one of them. This new statistical series should apply a single concept of control, but continue to employ both the CALURA and IIP concepts in categorizing ownership, as discussed above. The statistical element of the Industry, Trade and Commerce guidelines programme could be terminated and Section B of Part I of CALURA repealed. Making use of its general statistical power, Statistics Canada could publish an annual review of foreign ownership and control in the Canadian economy, with a greater number of statistical series breaking out the Canadian controlled and the foreign controlled sectors.

(ii) Consideration could be given to developing a single group within Statistics Canada to collect and compile relevant foreign investment data.

(iii) The data for economic analysis might be improved by: (a) the subdivision of basic statistical series between Canadian controlled and foreign controlled firms and by country of origin; (b) filling the gaps in information—particularly the data on international transactions (foreign trade by individual companies, non-merchan-

dise transactions, etc.), sources of funds, retained earnings in Canada, etc. Where relevant, these data should show the country of source or destination and indicate whether the transaction was between affiliates; (c) the publication of industrial statistics relating to foreign ownership using the Standard Industrial Classification.

(iv) Information that is compiled with regard to foreign ownership and control should preferably concentrate more on control than on ownership, but continue to provide data on ownership based on the two concepts employed by CALURA and IIP.

(v) Statistics Canada, in cooperation with interested departments and agencies, could determine which statistical series should be published annually, which regularly but not annually, and which only occasionally.

(vi) If the compilation of data on foreign control involves the use of a size criterion, as at present is the case under CALURA, consideration could be given to having Statistics Canada undertake periodic surveys of corporations excluded by the criterion.

(vii) In seeking to determine intercorporate links, information could be requested on the ownership of shares not only from corporations and non-resident persons (as at present under CALURA), but also from persons resident in Canada.

(viii) Consideration could be given to asking the OECD to introduce and maintain a series of statistics on the behaviour of foreign controlled companies in various countries.

REVIEW PROCESS

(i) A review agency should probably have legislative authority to obtain that information required for the operation of the review mechanism. It would also need basic economic and industrial information on individual companies similar to that received under the IT&C guidelines programme and by Statistics Canada. If the agency cannot obtain this material from Statistics Canada, it would require legislative authority to obtain it directly from Canadian companies—whether Canadian or foreign controlled. The agency would also need legislative authority to require companies to report on the fulfilment of any undertakings given to the review authorities.

(ii) Consideration could be given to providing that changes in the requirements regarding the control of what is reported to the review agency be made by regulation, rather than legislation in order to provide more flexibility.

(iii) The review agency could undertake special studies on aspects of foreign ownership as directed by the responsible minister.

(iv) The review agency could be given access to the information collected on foreign controlled companies by other government departments and agencies if it is to review the degree to which the broad objectives of the government's foreign ownership policy are being met in these fields.

(v) The review agency could be authorized to keep a record of all government assistance to foreign controlled firms, whether originating from the federal or provincial governments.

DISCLOSURE

The revised *Canada Corporations Act* goes only part way in providing for disclosure of the operations of individual companies, especially those that are private. Consideration might be given to further improving the Act by requiring greater detail in reporting—on the profits of various lines of business in a single corporation, for example. Alternatively, consideration could be given to converting CALURA into a general disclosure statute applying to all Canadian companies above a certain size.

Chapter Twenty Three

INTERNATIONAL INITIATIVES

INTRODUCTION

The study to this point has been concerned, in part, with the ways in which foreign direct investment affects the domestic economy. It has also examined the effectiveness of various domestic policies dealing with the problems posed by foreign direct investment. A number of alternative means of enhancing the net benefits which Canadians receive from foreign direct investment, increasing domestic control of the national economy, and assisting in the development of indigenous industry have been raised for consideration.

In the previous discussion, little attention has been given to the possibility of looking to international cooperation as a means of easing the problems which foreign direct investment and the multinational enterprise pose for Canada, which is the subject matter of this chapter.

There are four main arguments for looking at the possibility of international cooperation. They are:

(i) that it may at times be difficult to enforce certain Canadian laws and policies due to the capacity of foreign controlled firms (and to a lesser extent Canadian controlled MNE's) to circumvent them;

(ii) that the capacity of the foreign controlled firm to play off one government against the other reduces the net benefits to Canada from foreign direct investment;

(iii) that foreign direct investment can serve as the vehicle through which foreign laws and policies are transmitted to Canada; and

(iv) that, more broadly speaking, the rights and responsibilities of host and home governments *vis-à-vis* subsidiary and parent firms (and *vice versa*) require clarification because the absence of internationally accepted rules raises the possibility of growing areas of international conflicts.

It will be noted that the first two problems listed above are essentially ones which pit the foreign controlled firm against the host government, whereas the latter two are basically concerned with the relationship between host and home governments.

PAST INTERNATIONAL COOPERATIVE APPROACHES

A number of international measures have been adopted in recent years to mitigate the difficulties which arise out of direct investment flows. They have not thus far been particularly effective or far reaching.

(i) Bilaterally, arrangements exist with a number of countries. For instance, an arrangement between Canada and the United States provides for consultation between the two governments whenever the enforcement of one country's competition law will affect the other.[61] There is also the so-called Eisenhower-Diefenbaker understanding, which affects the application of the United States *Trading with the Enemy Act* to Canadian subsidiaries of United States firms.[62] Double taxation agreements in the past removed some potential difficulties, but have not dealt in a comprehensive way with transfer pricing problems.

(ii) In the multilateral context, a number of steps have been taken, particularly in OECD. A code has been worked out to deal with capital movements. Although Canada has not signed the Code, Canadian policy regarding capital movements is more liberal in practice than that of most countries which adhere to it. OECD has also worked out a draft convention on the protection of foreign property, but it is not binding on OECD governments. For a number of years, discussions have been under way in OECD aimed at securing international cooperation on restrictive business practices. Little progress has been achieved to date.

HOST GOVERNMENT VERSUS MULTINATIONAL ENTERPRISE (MNE)

One way in which the interests of host governments may be hampered by the MNE generally, and by foreign controlled firms in particular, is through their greater capacity to circumvent national laws and policies. These points have been discussed elsewhere. The point which must be observed here is simply that in matters of anti trust, taxation and possibly others, effective enforcement of national law often requires either bilateral or multilateral cooperation.

There is much competition between national (and junior) governments to attract foreign investment. Tax concessions, subsidies and a long list of other incentives can and are used to draw investments into one jurisdiction, rather than another. The result is to reduce generally the net benefits obtained by the capital importing countries as a whole. Some form of international cooperation between governments might minimize this difficulty. In the past,

[61] See Chapter Sixteen.
[62] *Ibid.*

the ability of the Canadian government to participate in such efforts seems to have been affected by the absence of an instrument through which an agreement could be implemented, particularly in view of the freedom of the provinces to offer incentives.

HOST GOVERNMENTS VERSUS HOME GOVERNMENTS

In the past, foreign controlled firms have, directly or indirectly, been a vehicle for extending the laws or policies of foreign governments to Canada.[63] This has posed problems both for the governments and for the firms concerned. In general, the kind of case-by-case solutions reached have not been very effective from the Canadian viewpoint.

Another kind of problem, which may be even more important in the future, is that governments are likely to begin struggling over the MNE to have it locate activity in their jurisdiction. In the United States, for instance, parts of the labour movement have been exerting pressures on the United States government, directly and indirectly, to retain more production in the United States. Other countries, particularly host countries, endeavour to negotiate for as much activity as possible in their jurisdictions. Thus, conflicts over extraterritoriality and economic activity are likely to grow.

POSSIBLE FUTURE DEVELOPMENTS

It is quite possible that the existing situation could continue more or less as is for some time, perhaps with progress in limited areas. However, given the expected pace of its growth, pressure to control the MNE seems likely to increase. These pressures will emanate in part from governments, either on their own initiative or due to the impact of interventions by other governments.

A second possibility is that international businessmen will become concerned about being put under pressure from more than one government. Should complaints from business grow, and should governments prove either unwilling or unable to agree about the relationship between international business and interested governments, it is possible that the major MNE's might try to work out arrangements among themselves to protect their interests.

The third alternative is that governments may become more disposed to developing measures multilaterally and bilaterally to cope with the problems on an acceptable basis.

In the circumstances outlined above, a number of options for Canadian policy arise for consideration.

[63] *Ibid.*

Firstly, a Canadian initiative could be taken, aimed ultimately at the establishment of an international code setting out both the rights and responsibilities of home and host governments in respect of parent and subsidiary firms, and of parent and subsidiary firms in respect of home and host governments.

Such a code might contain some of the following elements:

(i) recognition by home governments that foreign affiliates of their national firms are not, in principle, to be used as the vehicle for the extension of their laws into foreign countries;

(ii) the obligation of host states to act in a fair and equitable manner (terms which would require defining) toward foreign investment;

(iii) renunciation by a government which itself engages in foreign direct investment of any special rights, privileges or status for that investment by virtue of its being made by or on behalf of a government;

(iv) providing *Most Favoured Nation* treatment to foreign investors, rather than national treatment. This would guarantee investors from any country signing the code that they would be treated no worse than firms from any other foreign country;

(v) recognition of the right of host countries to fix rules to ensure adequate domestic control of their economies.

The appropriate forum for such an initiative would require careful consideration. OECD, GATT or UN are all possibilities.

In the shorter run, existing work in OECD on the multinational enterprise could usefully be continued and expanded. Some studies on the multinational enterprise are already being carried but by an OECD Working Group and there are signs of willingness to move ahead in this area. Canada could take the lead in suggesting ways of actively pursuing this work in relation to a number of the specific problem areas outlined earlier in this section, possibly with a view to ultimately setting the stage for agreement on a code. Particular attention should also be paid to the need to build up adequate data on the multinational enterprise and its activities.

At the same time, while the thrust of Canadian efforts might preferably be directed toward the multinational approach for a number of policy reasons, there may nevertheless be certain areas in which bilateral arrangements are the best short-run answer.

Pending international action on either a multilateral or bilateral basis, however, it is reasonable for Canada to consider the adoption of national policies to deal with some of the problems presented by foreign direct investment. In all likelihood, such policies would complement, rather than conflict with, any international cooperative approaches that may eventually be adopted.

Part Five

CONCLUSIONS AND IMPLICATIONS

Part Five

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Chapter Twenty Four

CONCLUSIONS AND IMPLICATIONS

This chapter sets out the main conclusions which can be drawn from the findings and analysis above and examines their implications for government policy. It is concerned with three main issues: the nature of foreign direct investment and the multinational enterprise; the impact of foreign direct investment and the multinational enterprise in relation to a number of factors of major concern to government, including sovereignty, economic growth (nationally and regionally), the level of employment and quality of life; and the implications of this impact for public policy.

THE NATURE OF FOREIGN DIRECT INVESTMENT AND THE MULTINATIONAL ENTERPRISE

The discussion below deals separately with the three following matters: the nature of foreign direct investment in manufacturing; the nature of foreign direct investment in resources; and the nature of the multinational enterprise.

THE NATURE OF FOREIGN DIRECT INVESTMENT IN MANUFACTURING

Foreign direct investment in manufacturing is essentially an industrial phenomenon—a package which consists of a saleable product, technology, management, markets and capital. This package brings with it a mixture of benefits and costs. The distribution of the benefits and costs among the investor, the Canadian economy and the home economy is examined in more detail in a later part of this chapter. In this first part, attention is focused on two main structural characteristics of foreign direct investment in manufacturing: the truncated nature of subsidiaries; the miniature branch plant replica effect, which is the form of plant structure often found in Canada.

To attempt to explain fully the reasons for and significance of these characteristics, the discussion below focuses on the ways in which the foreign investor, the Canadian economic environment, and the international

economic environment have interacted both to determine the industries in which foreigners have invested and to shape the nature of the manufacturing subsidiaries in Canada. Because such subsidiaries account for well over half of Canadian manufacturing, these characteristics inevitably have an important bearing on the overall performance of the Canadian economy.

Distinctiveness as a Determinant of Foreign Sales

To understand the nature of foreign direct investment in manufacturing, it is necessary to begin by reviewing the factors which enable a foreign firm to sell in Canada, because both investment and trade are based on the ability of a firm to market its products successfully in this country.

The concept of "distinctiveness" is central to an understanding of both trade and investment flows. It implies the existence of some particular capacity of the firm which makes it competitive in the host economy, e.g., cheaper access to a factor of production such as capital or labour, technological superiority, or the achievement of significant economies of scale. Alternatively, the distinctiveness may lie in product differentiation, which may be based on real product differences or on factors relating to market image only. Distinctiveness may also result from market power, which simply means that few alternative sources of supply for a particular product exist. Distinctiveness, in other words, is what makes a product marketable in a country outside the one in which it has been developed.

The concept of distinctiveness as outlined above includes the classical concept of comparative advantage (i.e., factor endowment and relative factor prices), but goes beyond it. International trade theory demonstrates that exports may result from a distinctive capacity other than comparative advantage as it was defined in classical terms, namely the exporter's advanced technology, his distinct market image or his market dominance. These same factors can also influence investment.

The distinctiveness of a manufacturer may enable him to extract a premium from the host, or purchasing, economy which is considerably higher than the minimum return needed for the business transaction to be attractive to him. Accordingly, there may be a fairly wide range of returns over which he considers the investment or sale is worthwhile.

The factors which enable an economy to generate distinctiveness and the factors which lead an economy to be receptive to a foreign distinctiveness were discussed earlier.[1] In the main, the Canadian economy has been a recipient of such distinctiveness. Its proximity to the United States, the common language shared with Americans by English-speaking Canadians, advertising spill-over, similar tastes, and high wage and educational levels, have all helped make Canada a receptive market for foreign, and especially United States, distinctiveness in the case of both producer and consumer goods.

[1] See Chapter Three.

Once the foreign manufacturer concludes that he can market a significant volume of his goods in this country, he must decide whether he will do this by exporting to Canada, by establishing productive facilities here through direct investment, or by licensing. Various factors will help to shape the decision of the foreign manufacturer. These include: his business objectives; some of the cost and other characteristics of the host economy, including the policies of its government; transportation costs; the policies of the investor's home government and that of other governments; and the particular corporate circumstances of the foreign investor.

The objectives of the international investor are likely to include a combination of profit, growth, market position, security, and a variety of arbitrary factors. In pursuing these objectives, the foreign manufacturer may prefer to invest when there is the threat of indigenous competition developing in the country in which he is planning to market his goods, or when he feels investment will strengthen his position against international or domestic competitors. The foreign manufacturer's perception of his firm as a world-wide operation may also lead him to prefer to invest.

Conversely, if he has nationalistic biases he may prefer to export, rather than to invest; and if he feels that there is a foreign exchange risk he may want to minimize the amount of capital he is prepared to expose to that risk.

The cost and other characteristics of the host economy are factors the manufacturer has to take into account. The size of the Canadian market in relation to the economies of scale in production is one consideration. Where the Canadian market has not been able to support a Canadian-based manufacturing or assembly plant at a reasonable cost, the foreigner has usually produced at home, or in a third country, and exported to Canada.

In making this cost calculation, it is not enough for the foreigner to consider only the size of the Canadian market. He has also had to weigh the effect of the Canadian tariff and the other considerations affecting his cost of production in Canada. By producing in Canada, the cost of the tariff can be avoided. In earlier years, preferential tariff access to Commonwealth markets was also an important factor influencing the location decisions in some industries, since it increased the markets open to Canadian production.

Canadian labour costs, in comparison to those in the United States, may have been a less important factor in attracting manufacturing activity to this country, despite somewhat lower wage rates in Canada. This is primarily because the lower wage rates have tended to be offset by the lower productivity of Canadian industry. The lower levels of productivity have been partly due to the less efficient industrial structure in Canada and to the tariff, which has helped encourage such a structure. Wage rates and productivity vary from region to region and industry to industry in Canada and the United States. The comparison of labour costs between Canada and the

United States of interest to the investor is the comparison in the particular industry in which he is located, taking account of the regions in the United States or Canada in which he might conceivably produce.

The costs of manufacturing in Canada are also affected by the price of materials and machinery and equipment, which tends to be substantially higher in Canada than in the United States—which is in part also due to the Canadian tariff.

Production costs in Canada are also affected by the availability and efficiency of the Canadian economic and social infrastructure—the transportation and communications system, the educational facilities, and so on. Adequate facilities of this nature are generally available in Canada, tending to make investment more attractive and more profitable.

Non-cost factors are also important. The relative political stability in Canada has made it easier for the foreigner to have confidence that there would be no government takeover of his investment without compensation. The absence of government restrictions on foreign investment in manufacturing, and the freedom of the manufacturer to repatriate earnings and capital on his investment, are further factors that add to the attractiveness of locating productive facilities in Canada.

Marketing factors also influence the investment decision. For products which require after-sales service, the manufacturer has an added incentive to locate some facilities in Canada. In other cases, the need to be "in the market" may encourage investment, e.g., in cases where it is very difficult for the foreigner manufacturing to get access to critical wholesale or retail outlets in Canada unless he is producing in Canada. If adaptation of products to local tastes is an issue, this marketing requirement may be further strengthened.

Transportation costs can also be a consideration in leading the foreign manufacturer to invest, rather than to trade. The importance of transportation costs will, of course, vary from case to case, depending on the nature and value of the product, the distances involved, the kinds of transportation facilities available and the myriad of other factors relevant to assessing relative transportation costs.

The policies of the home government and other foreign governments can also influence investment decisions. For instance, special tax rates may be offered by foreign governments to encourage manufacturing firms to export from their home base, rather than to market through investment abroad (even though this may raise the issue of dumping). Restrictions can also be imposed on exports of capital with the same objectives in mind. Conversely, for processing or fabricating activities which are particularly likely to pollute the environment, home countries may provide incentives to invest and carry out a part of the production activities abroad, rather than at home.

In addition to cost and marketing factors, and the attitude of the host government, the decisions about whether to invest or trade may depend on the particular circumstances of the foreign manufacturer. He may have

reached a threshold in his operations at home and be seeking an opportunity to market his distinctive capacities abroad through trade or foreign direct investment. If he has unused capacity at home, he may be less inclined to invest in the establishment of additional production capacity abroad and rely more on opening new markets through exports.

Factors Shaping the Characteristics of Foreign Direct Investment in Manufacturing

The same factors which help determine if foreign manufacturers will market their goods through investment, rather than trade, are also among the most important factors shaping the nature of the investment. They include: the economies of scale in the various functions performed by the firm; factors affecting costs in Canada, especially the tariff; marketing considerations; and, finally, the operation of the international market-place.

Those functions which do not require production in very large volume to achieve the minimum efficient scale for economic operation are likely to be those which a manufacturer will first consider undertaking abroad, depending, of course, on the size of the foreign market. If functions of this volume are to be found in the advanced stages of production—in assembly operations, for example—then the investor will be inclined to locate those facilities in foreign markets most quickly.

Secondly, the Canadian tariff has an important bearing on the nature of the investment. On the whole, the tariff has tended to offer protection across a very wide range of manufacturing activity, rather than concentrating protection in some areas and leaving other large areas of manufacturing activity entirely open to imports. This has meant that the tariff has encouraged the foreigner to manufacture or assemble his entire product range in Canada, rather than having his Canadian plant specialize in producing one product for the Canadian and international markets.

Furthermore, the tariff is structured so that the highest rates are normally on the most fully manufactured items, even though there are important exceptions. The effect of having nominal tariff rates which escalate with the increasing degree of manufacture is to put the highest rates of effective protection on the finished product. This means that the incentive to locate production is greatest for the latter stages of activity.

If Canada in its earlier days had pursued a competition policy which recognized both the importance of economies of scale and the need to have alternative suppliers to create market pressures for efficient production and dynamic innovation, then any anti-competitive effects of the Canadian tariff could have been either mitigated or avoided. But Canadian competition policy has not been structured in an effort to any anti-competitive effects of the Canadian tariff. Indeed, it has done little to compensate for any anti-competitive effects of the tariff and the resulting scope for investors to produce in Canada at costs which are not competitive internationally while still earning a reasonable rate of return on their investment.

To the extent that marketing factors are important, they do not require the investor to locate the full range of his activity in Canada. Indeed, he may only require some of the later production steps to be near the ultimate customer in order to provide after-sales service or to determine the need for adaptation. Transportation costs, in general, seem to be greater on higher priced finished products than on various inputs. To the extent that they are important, and their importance has been diminishing for some time, they also encourage investment in Canada at the later stages of production.

The extent and nature of foreign direct investment in Canada is also influenced by the global objectives of the foreign investor—particularly in the case of the multinational enterprise (MNE)—and by the operation of the international market-place. The competitive forces working in the international market-place to allocate investment are often distorted by the intervention of government. They may also be distorted by the nature and structure of the MNE itself, which is frequently heavily shielded from competitive pressures by the oligopolistic structure in various industries.

The international firm often has a combination of objectives, as noted earlier. It may, therefore, make investment decisions which are not based simply on a comparison of the underlying costs of producing in the different economies in which it does business. Furthermore, the speed with which it adjusts to cost differentials may be slower than would be justified by the cost comparisons alone. Investing abroad generally carries with it an added element of risk, which a firm may only feel justified in taking if the cost differential is significant.

When the investing firm has a degree of market power, it may be able to invest in order to prevent new competition from springing up, or to forestall or offset an investment decision by an international rival. Although this may not necessarily be the best means of generating maximum short-run profits, or be responsive to differences in costs of production, the decision to invest may well be warranted in view of the firm's longer term growth or market position objectives. In deciding this, the investor may be locating economic activity based on criteria other than immediate cost considerations alone.

Furthermore, once a firm with a degree of market power has made an investment in production facilities in one country, it may not be profitable for it to duplicate these facilities elsewhere in response to changing comparative costs. With its committed investment, it may be more profitable for it to remain in the higher cost jurisdiction. Some companies, however, may fail to take advantage of significant cost advantages in other countries simply because of inertia. Faced with rising competition from such areas, these companies may eventually call on their home government to provide them with increased protection to enable them to remain in business.

Some firms, particularly in high technology industries, are constantly innovating and doing so from the home base. Owing to the relatively short

life span of some of their products, they are constantly living in the short run. By the time sufficiently large markets have been built up abroad to justify some investment in foreign markets, new products are coming on stream. Therefore, they may never find it necessary or attractive to invest abroad to any great extent.

Alternatively, if the life span of the product is long enough to justify foreign investment, the different economies of scale for the different functions and activities which go into the making of the end product may mean it invests only in certain activities abroad. For example, an inventor is often ready to establish a Canadian assembly plant before he is ready to manufacture components in this country. This tendency will be reinforced if he has under-utilized capacities at home for the manufacture of components, thus further increasing the likelihood that the investment will be restricted to assembly in Canada, with components or other inputs supplied from production abroad.

These factors taken together may mean that investment decisions of the foreign firm are not necessarily responsive to changes in long-run cost and efficiency of different national economies. Nevertheless, such decisions may make perfectly good sense, since the investor is intent on maximizing his objectives based on the time horizons which seem to be most relevant to his business.

The subsidiary of the MNE, especially during its earlier years in Canada, may also know less about its new environment than its Canadian competitor. It may be less aware of the availability of Canadian components and services and more cautious about dealing with these unknowns. Thus the subsidiary may choose to use the same advertising or engineering services as the parent without even canvassing the possibilities of finding Canadians who can do the same job. This tendency can be reinforced by the desire of the parent to exercise control over its world-wide operations.

The capacity of the international businessman to partially subordinate his short-term goal of minimizing costs to the pursuit of longer term economic objectives—such as growth, market dominance and security—is thus determined in part by the way in which the international marketplace allocates resources. When it is efficient, activity tends to be located in the countries with lowest costs. But the market-place in many instances does not work this way. Many industries in which foreign direct investment in Canada is high are also ones characterized by oligopolistic structures internationally. Such industries tend both at home and abroad to be dominated by relatively few firms in a position to wield strong market power.

Even the maximization of profits for firms with strong market power need not entail maximum production levels and/or minimum unit costs if the firm is able to charge higher prices for lower levels of output. As a result of the relationship of more favourable revenues to costs at such a restricted level of output, the firm may be able to realize substantially greater profits than could be gained through increasing sales by lowering prices.

Governments also intervene in the process by which resources are allocated internationally in order to increase the contribution that firms within their jurisdiction make to the attainment of national objectives. Restrictions on trade and on capital movements, as well as measures designated to influence the location of economic activity—such as the United States Domestic International Sales Corporations (DISC) legislation, location grants, tax privileges and government procurement regulations—have an impact upon the decision-making of these large firms. The result of such intervention by governments is to further distort the normal forces of the market and the role it might otherwise play in the international allocation of resources. For instance, foreign tariffs are typically higher on finished goods than on raw materials and semi-manufactured goods, thus restricting the export opportunities of Canadian manufacturers of finished goods. Foreign government tax law may subsidize foreign investment by its nationals in resource exploitation, but make such investment relatively less attractive in manufacturing. Capital restrictions may similarly encourage or discourage direct investment abroad, depending on the nature of the investment. The pursuit of such policies by foreign governments may, in turn, have an important bearing on the structure and nature of the Canadian economy.

Even if public policy were directed to making the Canadian manufacturing sector much more cost competitive, there is no assurance that business firms would favourably respond in the way that would be expected on the basis of classical economic theory. This is due to the distortions in the international market-place resulting from government intervention and the structure and nature of the MNE—particularly those within industries that are highly oligopolistic. As a result of such distortions, the competitive conditions in many industries are simply not sufficiently free for the classic theories on resource allocation to apply effectively, thus ensuring that Canada will have the investment and industrial structure which is in keeping with its economic potential. This does not mean that the goal of lowering costs and increasing efficiency should be ignored, nor that progress toward that goal will not play a part in resolving Canada's economic problems. Reducing costs and increasing efficiency may be only a partial answer, however, to the problems posed by the industrial structure of the economy and the nature of foreign direct investment in Canada.

In summary, the nature of foreign direct investment in manufacturing reflects the distinctiveness of the foreign manufacturer and a number of other factors—the objectives of the investor, the cost competitiveness of the Canadian economy, Canadian and foreign government policies, marketing considerations, economies of scale in different function, the relative costs of transportation at different stages of manufacture, and the operations of the international market-place.

These various factors interact in a way which has produced the structural characteristics of the foreign direct investment in Canadian manufacturing.

The key characteristics—truncation and the miniature branch plant replica—are explored more fully below.[2]

Truncation and Marginality

Perhaps the most common characteristic of foreign investment in manufacturing is its truncated nature. A truncated firm is one which does not carry out all the functions—from the original research required through to all the aspects of marketing—necessary for developing, producing and marketing its goods. One or more of these functions are carried out by the foreign parent of the Canadian firm.

There are several reasons for a parent to truncate the operations of its foreign affiliates. Truncation may be necessary to enable the parent company to achieve the maximum economies of scale inherent in the centralized functions which it performs, thus constituting an efficient international distribution of corporate activity. It may be most efficient, for example, for the parent to undertake all the research and development of the international enterprise, rather than having part or all of it undertaken by subsidiaries. Truncation of the subsidiary's operations in Canada may also come about because the foreign parent or some of its affiliates in other countries have an under-utilized capacity to supply inputs required by the Canadian firm, such as components or services. Truncation of the Canadian subsidiary may seem advisable to the foreign parent to minimize the investment risk, to reduce the danger of making available training and know-how to Canadians who might subsequently employ it to become a competitor, or to give the parent maximum flexibility to draw off profits from the subsidiary through royalties or management fees or the prices charged for inputs supplied to the Canadian operations.

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[2] "Truncation" is a term used to describe the nature of a subsidiary which does not itself carry out all the major functions usually associated with a modern corporate enterprise. The degree of truncation may vary substantially, depending upon the extent to which these functions are performed by the parent and/or other affiliates and the extent to which they are performed by the subsidiary in Canada. In one case, the parent may reserve to itself all the major managerial decisions, research and development and a variety of other functions. The parent may deny the subsidiary the right to export and require the subsidiary to accept from it a number of components and other inputs. Alternatively, the subsidiary may be permitted greater scope for undertaking management decisions within its own domain and some degree of research and development on its own. It may be internationally rationalized, producing part of the product line of the enterprise for sale in Canada and in the parent's markets abroad, while importing the remainder of the line from the foreign parent and other affiliates. Even in the case of international rationalization, the degree of truncation can vary, depending upon the extent to which the subsidiary plays a role in the research, development and marketing of the product which it produces.

"Miniature branch plant replica" is a term used to describe a subsidiary which adopts the same technology and techniques as the parent to turn out a virtually identical product line. The scale of operation of the Canadian subsidiary is in miniature by comparison with that of the parent, however, because its production is almost always restricted to the smaller Canadian market. The miniature branch plant replica is usually highly truncated, in that many of the most important corporate functions outlined above are performed by the parent. The reverse is not necessarily true, however. All truncated companies are not miniature branch plant replicas. They may undertake some of their own research and development or their production may be internationally rationalized with the parent, for example.

Truncation normally maximizes the achievement of the global objectives of the parent firm and is, from its point of view, a rational business decision. It does not necessarily maximize the profits of the Canadian subsidiary, nor its contribution to the Canadian economy. Depending on which activities are involved, truncation may mean less production for the Canadian market, less opportunity for innovation and entrepreneurship, fewer export sales, fewer supporting services, less training of Canadian personnel in various skills, less specialized product development aimed at Canadian needs or tastes, less spill-over economic activity, and so on.

In many instances, subsidiaries—especially those that are miniature branch plant replicas—do little or no research and development for most of their product lines. They are highly dependent upon foreign affiliates for the provision of certain components and services. They are often excluded by the parent from foreign markets even though, in some cases, these restrictions only recognize what the firm already knows—that its Canadian subsidiary is not efficient enough to sell to its subsidiaries as cheaply as the parent can, especially when the parent can make use of existing capacity to produce components for sale at incremental cost to a Canadian affiliate.

The nature and degree of truncation varies from one subsidiary to another. This may be the case even where there is extensive international rationalization of production between the foreign parent and its Canadian subsidiary. In one case, for example, part of the enterprise's product line may be produced in this country for sale both in the Canadian market and the parent's home market, while the remainder is produced by the parent for sale in its home market and in Canada. All of the management decisions, research and development and design of the product line may be undertaken entirely by the parent. Alternatively, however, the Canadian subsidiary may be given responsibility for designing, developing, and producing part of the product line for sale in markets both at home and abroad.

Under this kind of rationalization, truncation is substantially reduced, that which remains stemming from the parental authority to make the initial allocation of the product line and to approve subsequent important decisions—new capital investment, for example. Truncation of a subsidiary does not necessarily contribute to economic inefficiency in Canada. It may be the only way for the parent to reduce costs and locate the activity in Canada. Unfortunately, there is no *a priori* way of distinguishing efficient from inefficient truncation, in view of the distortions both in the domestic and international economy. This can only be determined by examining particular cases.

It is desirable to avoid or to minimize truncation where a particular product is important to the realization of national objectives. In those industries, Canada may wish to develop its own distinctiveness and to reduce its dependence on foreign innovation and technology so that it can have full control over the various stages of production. In addition to economic

considerations, Canada is also generally better off by minimizing truncation for broader social and cultural reasons, including the desire for a more stimulating environment and the development of more interesting and creative jobs.

Although it is desirable to minimize truncation, it may be particularly difficult to do so in industries where there is rapid product change. Short-run cost considerations are likely to induce the parent to supply the subsidiary's needs for components for its new products because of the investment it has committed at home to the production of these components and other inputs. If and when the Canadian market becomes large enough economically to justify a component plant of its own, the product may be phased out to make way for a new technology coming on stream. At best, component manufacture is likely to be shifted to Canada only for more mature products, and only then if Canada is a more attractive location for production than other countries—including the "low wage" countries.

There is no easy answer to this problem. In many cases this location decision will reflect the foreign businessman's accurate assessment of the higher costs of producing in Canada. In other cases, the decision of the businessman may not reflect the underlying competitiveness of the Canadian economy because distortions in the international market make it more profitable for him to produce elsewhere, or because of a variety of factors.

When cost considerations are the obstacle to Canadian production, the only solution consistent with industrial efficiency and higher living standards is to improve the cost structure and general efficiency of the Canadian economy. This, in part, is a function of various federal and provincial policies. Whenever these decisions about where to locate production are not based primarily on cost considerations, however, but rather reflect distortions in the international economic environment, the biases of firms engaging in foreign direct investment, or the policies of other governments, it may be possible and feasible to influence the decision through negotiations between the government and the firm concerned. This capacity to influence the decision in some of these cases may stem from the fact that the firm is already earning or expects to earn a higher return that is necessary to retain it in Canada or to attract it to this country. This leaves some room for the government to press the firm to increase its contribution to the Canadian economy. In other cases, it may be possible to develop plans for rationalization which will reduce costs, improve the structure of the subsidiary and bring benefits to both the investor and the Canadian economy. In the case of a foreign company planning an initial investment in this country, the market opportunities may be sufficiently strong to give the government some leverage with which to negotiate terms and conditions of entry that will better serve the interests of the economy.

In more extreme cases the truncated subsidiary can be described as a "marginal" operation. This implies that the subsidiary is heavily dependent

upon its foreign parent. The marginality of a subsidiary is in part a result of the economies of scale in production and marketing style for Canada.

By definition, marginal subsidiaries are geared to production and marketing techniques which they could not sustain if they were independent Canadian firms. This constraint reflects the fact that the Canadian market, and even the Canadian market and accessible export markets, would not be large enough to provide the economies of scale to permit an independent Canadian firm to do business in the way that it does as part of an international firm. For instance, a Canadian subsidiary of a foreign company may be locked into a rhythm of technology and design change which it likely could not afford if it were entirely independent. As subsidiaries, they only have to bear some small proportion of the overhead costs involved in doing business in this way. Should the Canadian subsidiary's links with its parent be cut, it would experience substantially higher costs per unit of output if it attempted to continue its former style of operations. It would, therefore, have to radically alter its method of operation or perish. So long as it retains its international affiliation, the subsidiary is dependent entirely on the inputs of design, technology and the marketing techniques of the parent.

A marginal subsidiary, just as is true of less truncated firms, may be a highly efficient operation. It is in the nature of the marginal operation, however, that it is very heavily dependent on its parent and lives off its technology, design and marketing methods. The subsidiary does not do research into the kinds of production techniques most suited to the relative cost of factor inputs in Canada and the size of the Canadian market. No effort is made to find techniques which reduce the costs of production for the volume of output appropriate to the Canadian market. Marketing methods are not geared to the size of the domestic market and income levels of Canadians. They are simply transmitted from abroad. In industries in which foreign firms dominate, they may be imposing a method of production and of doing business on Canada which are not the most appropriate for the Canadian economy. As a result of the market power they are able to exercise, however, the subsidiaries involved may be able to prevent the emergence of Canadian firms making competing products.

The concept of marginality also has an important bearing on the argument that Canada should, as part of basic policy, "buy back" the bulk of foreign owned or controlled companies in this country. In the case of many manufacturing subsidiaries, at least, this is generally not feasible because the body is not of much use without the brain and other vital organs and they are abroad. The subsidiary—the body—may be worth a lot to the parent which controls it. But left on its own, it would wither away.

The distinctiveness of a foreign investor tends, if introduced through foreign direct investment, to enter as part of a total investment package. The investor may have some distinctive technology or a distinctive product, but through direct investment operates a Canadian subsidiary which is tied to

the parent for more than simply the distinctive element. Other inputs such as components, supplies, capital and managerial direction may all be attached to the distinctiveness. These other elements may be neither distinctive nor efficient, but be "tied in" to the package. Similarly, restrictions on export opportunities or procurement freedom may also be attached as a condition imposed on the host economy for access to the distinctive element.

The tied package may be expensive. It may also retard the development of indigenous Canadian capacities in functions related to the activity on which the investor's distinctiveness is based. In so doing, it can prolong the special return to the distinctiveness obtained by the investor, as Canadian competitors are not likely to emerge if the surrounding support functions which may be important in developing a competing distinctiveness are not given an opportunity to grow and mature in Canada.

If the distinctive capacity could be obtained without the other ties or restrictions, the Canadian economy might be better off in many cases. Licensed importation of technology, joint venture participation by Canadians and the reduction of restrictions are all possible techniques for severing the package where this can be beneficial for Canada.

The Miniature Branch Plant Replica and Rationalization

Although it constitutes a simplification of the situation in the real business world, foreign controlled manufacturing firms can generally be described either as "miniature branch plant replicas" or "rationalized". In reality, of course, the way in which such firms operate may vary widely between these two extremes. The miniature branch plant replica is a shorthand way of describing subsidiaries which produce in their Canadian plants most or all of the product range and the variety of models of their parent, and which carry out these production activities using the same production techniques as the parent.

Rationalized firms normally restrict their activity to particular lines within the production range of the foreign firm with which they are associated and may even restrict themselves to particular functions (e.g., production only) in those lines in which they specialize.

A number of factors help to account for the frequency with which the miniature branch plant replica is found in Canada. One is the Canadian tariff which, as already mentioned, provides an inducement to foreign manufacturers to locate a large range of their product lines in Canada.

The foreign manufacturer has sunk costs in each of the products and models in his range. Owing to his sunk costs in research, development and design, it makes sense for him to use the same production methods in Canada as he has developed elsewhere. Accordingly, once he finds that the costs of importing imposed by the Canadian tariff and transportation are together greater than the savings which he would obtain from specializing in

production of some lines and importing others, he normally has little inducement to undertake the necessary capital expenditures to develop new production techniques suited particularly to the Canadian market size. The miniature branch plant replica results. The same products and models are made in Canada as in his home base using the same production techniques.

The relatively high levels of effective protection afforded by the tariff in some industries increase the landed price and, therefore, the potential volume of imported goods in competition with domestic products. Although of less significance, the absence of a vigorous domestic competition policy has also helped to reduce the likelihood of low priced domestic competitors emerging. The prevalence of international oligopolies in many of the same industries protected by tariffs might tend to perpetuate such conditions even if these tariff barriers were lowered and the opportunity for competition from abroad increased. These factors help make it possible for subsidiaries to produce profitably at high costs and makes the miniature branch plant replica a viable form of business operations.

In other cases, frequently because of Canadian government intervention, the operations of Canadian manufacturing subsidiaries may be rationalized in various ways and degrees. The production of certain products or models may be undertaken by the subsidiary for sale in Canada and for export abroad, with the remaining lines being imported from the foreign parent or another affiliate. Rationalization can involve the subsidiary specializing in the production of one or more components for the parent. It can involve the subsidiary being given full responsibility for the development, production and marketing at home and abroad of a particular product or line. Or it can take some other form within this broad spectrum. In general, rationalized subsidiaries operate more efficiently than subsidiaries which tend towards the miniature branch plant replica form because they are better able to achieve the economies of scale which are available.

So long as the Canadian affiliate of the foreign manufacturer has to pay a significant duty on imports of part of his product line, there is little incentive for him to rationalize. Even if Canadian duties were reduced on certain items, it is by no means certain that rationalization would occur. The possibility of intra-firm rationalization across international borders could continue to be affected adversely by the tariffs and restrictions which other governments impose upon imports of manufactured products. Rationalization between foreign controlled Canadian subsidiaries or between a subsidiary and an independent Canadian firm is even more difficult to achieve through the use of general economic policies. Once a foreign manufacturer has made heavy expenditures on the development of a range of products, he will want to market all of them in Canada. He has no reason to stop selling any of his products in Canada unless and until one of his competitors is able to sell in Canada at such low prices that it is no longer profitable to remain in that product.

However, if and when market forces lead to the creation of a firm able to specialize in one of the lines made by the miniature branch plant replica, and to enjoy the benefits of economies of scale in its production, the miniature branch plant replica may no longer find it viable to continue the existing high cost production of that line. This kind of pressure can force the subsidiary to reassess its own production activity and to look for longer runs. But so long as foreign government import restrictions exist, the Canadian subsidiary has little opportunity or incentive to rationalize in a way which would involve export to the various markets of its parent.

Conclusions

Three principal conclusions follow from the analysis above. The first is that foreign direct investment in manufacturing is essentially an industrial phenomenon. The foreigner has a distinctive product or technology he is able to sell in Canada. He has to decide if he should market his distinctiveness through trade or investment. This decision is not based mainly on the availability and cost of capital in different countries, but rather on the non-capital factors which have been discussed above—tariffs, transportation costs, labour costs, marketing considerations, political stability, the competitiveness of the international environment, and so on. As an industrial phenomenon, foreign direct investment involves a package which includes a saleable product, technology and production method, management, a marketing strategy (including a mixture of costs and benefits associated with that strategy) and capital.

Secondly, the truncated nature of foreign direct investment in manufacturing and the frequency of the miniature branch plant replica are influenced by a myriad of factors, some of which are under the control of the Canadian government—such as tariff and competition policy—and others which are beyond the reach of the policy instruments now employed by the government.

Thirdly, the foreign investor can frequently earn a larger return than the minimum required to attract him to Canada and induce him to remain here —often because he is well insulated from competitive pressures. His distinctiveness may give him some market power. If he is in an industry which is concentrated internationally, his position is further strengthened because of the limited degree of global competition. In industries where the Canadian competitive environment is weak, he is further shielded. Government policies affecting international trade and investment also affect competition—and hence his market power. The fact that he earns an attractive return on his investment may mean that there is scope for improving the net benefits to Canada from foreign direct investment without driving away the investor. In addition, however, there may be scope for making the operation of the foreign controlled firm more compatible with Canada's industrial objectives in ways that do not reduce the benefit to the foreign investor—through rationalization, for example.

THE NATURE OF FOREIGN DIRECT INVESTMENT IN NATURAL RESOURCES

The factors which account for the high level of foreign direct investment in Canadian resources are related both to the objectives and circumstances of the investor and to the circumstances of the Canadian environment.

The investor frequently wants secure access to raw or semi-processed materials for his processing or fabricating plant in the United States, Europe or Japan, prompting him to establish a vertical corporate chain leading backward to his source of supply. Canada's abundant natural resources and relative political stability help attract foreign investors who are interested in obtaining a secure and ample source of supply. In the case of United States investors, geographic proximity may be a further consideration.

The cost of resource extraction will also influence the investor. The economies of any particular investment will accrue as a result of a host of factors—for instance, the grade of ore, the costs of extraction, costs of transporting to markets, and so on.

Compared to some other countries which are rich in resources, Canada seems to be relatively advanced in its ability to provide investors with the infrastructure—roads, railways, airstrips, wharves—and the skilled technical personnel required for exploration and development. This, of course, has an important influence on the costs of extraction and transportation. Indeed, the availability of these factors—combined with the shortage of large pools of Canadian capital and Canadian entrepreneurship, and the problems faced by an independent Canadian enterprise in obtaining markets abroad—has contributed in substantial measure to the large inflow of foreign direct investment in Canadian resources.

Low Canadian taxes on resource extraction may also be important in some cases in drawing foreign investors to this country. In other cases, however, lower taxes may simply provide a gratuitous benefit to foreign investors who would be quite prepared to extract Canadian resources without special tax concessions.

The foreign investor may invest in Canadian resources to tie up supplies for the future, either with the aim of precluding indigenous Canadian development of the fabricated or manufactured products which he makes and/or to pre-empt supplies which his international competitors might otherwise be able to secure.

All these reasons help explain why foreigners have frequently been prepared to invest in Canadian resources. They also help explain why they have often integrated backward to the raw material supply, namely to protect their investment in processing, fabricating and manufacturing abroad.

In general, foreign direct investment in resources tends to be accompanied by less and less production activity in Canada as one proceeds from the extraction stage through to the milling, smelting, refining, fabricating and manufacturing stages, with more and more of these latter processes being

undertaken abroad. Large amounts of resources are exported in relatively unprocessed forms. Forward vertical integration to the smelting and refining stages by foreign controlled companies whose primary interest initially was extraction of resources is not uncommon, but fabricating and final manufacture is not a common phenomenon—except in the case of enterprises producing for domestic consumption.

In part, this reflects the *raison d'être* of many of the investors. They are integrating backward to get secure supplies for the fabricating and manufacturing facilities they already have abroad. From the firm's perspective, the decision not to process or to fabricate or to manufacture in Canada may be eminently sensible. This can mean that even where Canada is cost competitive in fabricating and manufacturing, the investor will continue to insist on this activity being conducted outside of Canada.

Reinforcing this position are the tariffs and other restrictions which most foreign governments impose on imports of fabricated and manufactured products. By allowing the import of raw materials duty free, and allowing in only partly processed goods at very low tariffs, other governments provide a fairly substantial degree of effective protection for the more fully processed items which are made in their countries. The high level of Canadian manufacturing costs, compared to the United States, and some gaps in domestic entrepreneurship, are additional but less important factors in discouraging forward vertical integration to the fabricating and manufacturing stages in Canada.

A less protectionist Canadian tariff structure and more competitive environment in Canada would reduce manufacturing costs in this country. In addition, Canadian tax policy could be altered in a way which might make it relatively easier for manufacturers—and relatively more difficult for resource exploitation firms—to raise capital. Higher taxes on resource extraction would presumably reduce the profitability of some projects sufficiently to reallocate capital resources of the lending institutions. But these steps would do little by themselves to encourage more fabricating and manufacture in Canada for export. So long as the tariff and non-tariff barriers of other governments are more restrictive against imports of more fully processed items and investors are mainly interested in secure supply of raw and processed material for committed investment elsewhere, a different mix of Canadian public policies would be required to achieve this objective. Such a policy mix must take account of the varying circumstances and needs of the investor, the degree of Canada's market power in particular resource industries and the feasibility of fabricating and manufacturing in Canada at competitive prices in the event that it is possible to get such activity located in Canada. This requires a flexible approach—one which recognizes that circumstances can vary from one case to the next over time, and which takes account of the problems of getting access to foreign markets for more fully processed products.

The multinational enterprise is the institutional embodiment of foreign direct investment by a single firm in several countries. The general determinants of direct investment apply also to the growth of the MNE. In manufacturing, the MNE generally invests abroad to obtain a greater return on its distinctiveness than it could by exporting. In the resource industries, the MNE tends to invest to obtain assured supplies for processing or fabricating facilities in the home or other markets. While not all foreign direct investment takes place within the multinational structure, the MNE is becoming increasingly significant as the vehicle for international flows of goods and services, capital and technology.

It is possible to view the MNE as a vehicle for reducing economic disparities between nations and improving world standards of living, in much the same way as international trade. But international markets have not been left sufficiently free to yield this outcome. Governments intervene, as noted earlier, restricting and distorting the play of competitive forces. MNE's have private objectives and biases which may further hinder competition. Furthermore, although the multinational enterprise was initially most significant as a vehicle for resource extraction in developing countries, the growth of the MNE in more recent years has been in manufacturing, with one industrial economy frequently investing in another industrial economy at a comparable stage of development.

The multinational enterprise establishes its profits, growth, market position and other objectives in terms of its world-wide operations. It is prepared to locate production initially in one country rather than another, or to shift existing production from one jurisdiction to another, in response to these objectives. But it is also important to recognize that despite their international perspective, most MNE's remain essentially national in character. The major single block of assets, sales and employment generally remains in one country. Senior management and the largest blocks of shares similarly are located in that one country. Therefore, in making these location decisions, the MNE will not only reflect cost, marketing and various other considerations, but also whatever degree of national bias it retains.

In contrast, national governments, including the Canadian government, are concerned about maximizing domestic objectives. These include the need for high levels of domestic employment, rising real incomes and the reduction of regional disparities. While this no means implies that there will be continuous difficulties between the MNE and the nation state, it inevitably does raise the likelihood of some conflict between the two as each pursues its objectives.

Government policy must recognize that the leading firms in many industries may be multinational in scope. It must also take account of the possibility within certain industries of encouraging the development of Canadian-based MNE's, recognizing the advantages in being home to the MNE, rather than host.

Even if there were more Canadian-based MNE's, however, that would not change the fact that there are a very large number of foreign based MNE's doing business in Canada, and that there can be, and often are, conflicts between the interests of the MNE and the Canadian government. To increase national control over the domestic economic environment, it would be necessary for the government to increase its ability to control or influence the activities of the multinational enterprise. This would require that means be developed to prevent MNE's from frustrating domestic policy by closing any existing gaps in present laws, improving the efficiency and cost competitiveness of the economy generally, by more direct intervention on the part of government where necessary, and by cooperative international action in some cases.

THE IMPACT OF FOREIGN DIRECT INVESTMENT ON THE ACHIEVEMENT OF NATIONAL OBJECTIVES

FOREIGN DIRECT INVESTMENT AND THE GENERAL ECONOMIC ENVIRONMENT

In the previous section of this chapter, the focus was on the part played by the domestic and international economic environment and by the economic policies of Canadian and foreign governments in shaping the structure of foreign direct investment. The discussion below focuses on the way in which the nature and operation of foreign controlled firms in this country affect the ability of Canadians to achieve their national objectives.

In trying to assess the impact of foreign direct investment in relation to Canada's national objectives, however, it is often difficult to distinguish between the impact resulting from that investment itself, the impact of the general economic environment in Canada, and the impact of the policies of Canadian and foreign governments, which, in turn, help to shape that environment. This poses an unavoidable problem because of the nature of foreign direct investment which is itself heavily influenced by the general economic environment and, at the same time, exercises some influence of its own on the environment.

NATIONAL OBJECTIVES

One of the underlying purposes of this study is to evaluate the impact of foreign direct investment on certain national objectives, including:

—political independence and sovereignty of the nation;
—rising living standards and strong economic growth, both nationally and regionally;
—opportunities for the meaningful employment of all Canadians;
—improvement in the quality of life.

The part played by foreign direct investment in relation to each of these objectives can be assessed by examining the impact of such investment on the following, each of which has a bearing upon one or more of the four national objectives listed above:

(i) the level of economic activity, including both output and employment;
(ii) productivity;
(iii) wage and income levels;
(iv) tax revenues;
(v) the nature of the competitive environment;
(vi) the nature of the nation's industrial activities;
(vii) gaps or deficiencies in indigenous capabilities;
(viii) domestic control of the national economic environment; and
(ix) culture or "way of life".

Effects of Foreign Direct Investment on the Level of Economic Activity

It is very difficult to quantify with any precision the past contribution of foreign direct investment to the level of economic activity and employment in Canada. For one thing, there is no way of knowing if Canadian entrepreneurship would have matured more rapidly in the absence of foreign direct investment; nor is it possible to know if the state would have intervened more actively to bolster Canadian economic performance. However, such studies as have been done by others—and they involve numerous qualifications—tend to suggest that the overall impact of foreign direct investment on economic activity has had a moderately favourable impact.[3]

The concern in this study, however, is not that of assessing the aggregate impact of foreign direct investment from a historical perspective. It is concerned, instead, with attempting to determine whether foreign direct investment might have contributed more than it actually has to Canada's growth, living standards and employment levels if there had been a different mix of national policies and if foreign investment could contribute more in the future with a different mix of policies.

Foreign direct investment often leads to an increase in the overall level of economic activity, particularly where the investment in question involves the undertaking of a completely new business venture. It is less likely to have the same result if the investment is for purposes of taking over an existing Canadian concern. The actual impact will vary from case to case, depending on a wide variety of factors: the way in which the Canadian resources used (human, capital, materials, etc.) might have been employed in the absence of the foreign direct investment; the level of employment and rate of inflation in the region in which the investment is made; the impact

[3] Rudolph G. Penner, "The Benefits of Foreign Investment in Canada, 1950 to 1956" *Canadian Journal of Economics and Political Science*, vol. XXXII, no. 2, May 1966.

on the exchange rate; the nature of the activity (e.g., resource extraction versus manufacturing); the capital intensity of the production process, and the multiplier effect of the investment. And even where the impact is positive, it is pertinent to consider whether the increases in the quantity and quality of activity and employment were the maximum which could be obtained in that case.

Two interrelated aspects of foreign direct investment which bear very directly on the contribution to the level of economic activity are the degree of truncation associated with the investment and the extent to which its operations are rationalized. In cases where foreign direct investment results in increases in exports and/or reductions in imports, the overall level of economic activity may be particularly enhanced. But where foreign direct investment does not result in an increase in exports and/or where the nation's imports are increased as a result of the purchase of components, service and other inputs from abroad by the foreign direct investor, its impact on the overall level of economic activity is much less certain.

A comparison of foreign controlled and Canadian controlled firms in terms of their relative export performance indicates little difference between the two categories. In view of the extent to which foreign controlled firms are normally integrated into the international resource allocation process, and in view of the marketing power of such firms, it is perhaps surprising that foreign controlled firms have not performed better than their Canadian counterparts. The fact that they have not is due in part to the restrictions placed on their offshore marketing activities, either indirectly as a result of the extraterritorial application of foreign laws or regulations, or more directly —and much more significantly—as a consequence of the international marketing strategies of their parent firm.

While the government could intervene in an effort to convince parent firms to remove or reduce those restrictions which they impose on the activity of the Canadian subsidiary, efforts to increase exports and greater domestic purchase of components and services also depend heavily on improvements in the competitiveness of the Canadian economy and on efforts to generate greater distinctiveness in this country.

It has been noted that foreign controlled firms import a larger proportion of their total purchases of goods and services than do Canadian controlled companies, and that this proportion seems to have been increasing in recent years. In may cases this high import propensity is based on sound business judgment. If the parent has developed a distinctive product, along with the appropriate components and supporting services, it is often more costly to the firm to have these inputs produced by local suppliers. There is likely to be a cost advantage resulting from economies of scale and a certain measure of convenience in producing such components in the manufacturing operations of the parent firm and exporting them to various subsidiaries.

However, the tendency to import a large proportion of components and services may have an adverse impact on the potential level of economic

activity in host economies such as Canada. In addition, such procurement tends to retard the development of related manufacturing and service activities in Canada. The effects of foreign direct investment on the overall level of economic activity in the host economy might be significantly enhanced if the foreign investor could be pursuaded to obtain a larger proportion of such inputs in this country. Greater overall efficiency could be achieved if the foreign investor could be influenced to rationalize his international production by locating manufacturing facilities in host economies such as Canada to supply both domestic and international markets with a particular product line which Canada can produce efficiently.

In many instances, foreign direct investment does bring with it new technology. The contribution of such investment to the overall level of economic activity could be further enhanced by the location of more research and development activities in Canada, provided it is economically viable and also provided that the commercially usable output of Canadian research and development activity is not exploited by the foreign parent in its production facilities abroad. Such exploitation would not only mean the loss of potential industrial activity in Canada, but also a waste of Canada's scientific and technical personnel. When the fruits of Canadian research and development are exploited in Canada, however, these can serve as the basis for creation of the distinctiveness needed to increase the level of economic activity in Canada through production for domestic and export markets. Although foreign controlled firms have historically spent proportionately the same as their Canadian counterparts on research and development in Canada, recent evidence suggests that Canadian firms may now be starting to spend proportionately more.

There is no way of determining without careful study, whether and to what extent any particular foreign direct investment may result in an increase in the level of Canadian economic activity and whether any increase is as great as it might be. Will it result in a sufficiently important contribution to the nation's growth and development, when considered against expectations and a reasonable assessment of potential? Will it create employment opportunities appropriate to the skills and aspirations of Canadians? Will it trigger events which either multiply or counteract its initially favourable impact? Only case-by-case analysis can provide an answer—in whole or in part—to these questions.

Influence of Foreign Direct Investment on Productivity

Foreign direct investment may have a positive impact on the productivity of Canadian industry by an injection of new technology or management skills, or more generally by providing a stimulus to competition. Moreover, foreign direct investment can have spill-over effects on productivity in related industries. Whether the economy will actually enjoy the maximum potential increase in its productive capacity as a result of any particular

foreign direct investment will depend on the nature and conditions of that investment and whether the Canadian market permits the subsidiary to realize the full benefit of the economies of scale provided.

Where productivity advances derive from new technology, the ultimate size of the benefit will depend in part upon whether the technology being transferred is well suited for the Canadian economy. Owing to the relatively small domestic market, many branch plants which utilize the technology of their parents may not derive optimal benefits, as the economies of scale available through the use of that technology may require more production than is justified by the size of the Canadian market. To achieve the further increases in productivity which are desirable, it may be necessary for the subsidiary to be free to export and/or to specialize in the production of certain product lines in order to take advantage of longer production runs and achieve economies of scale where they exist.

The price charged a subsidiary by its foreign parent for a new technology will also influence the net benefits obtained. If the subsidiary is charged a high price for the technology which it receives, this may draw some or all of the benefits to be derived from its use out of the Canadian economy.

The contribution a new technology can make to increased productivity in the Canadian economy as a whole depends on the speed and freedom with which it can be transferred from the Canadian subsidiary to all other possible users in Canada. Where the terms of transfer are restrictive, as permitted by patent legislation, which is very often the case, many potential benefits are not obtained. A restrictive attitude toward technology transfer is quite common, for both Canadian and foreign controlled firms, suggesting that the difficulty in this case is at least in part in the legislation which governs patents.

Productivity can very often be enhanced simply by the injection of managerial and other key labour skills. Where these skills are transferable, this often has spill-over effects in that Canadians in associated businesses may benefit from learning new ways of doing things. This notwithstanding, MNE's tend to guard jealously their key personnel. Particularly competent Canadian managers may be transferred to corporate operations in another country, thereby reducing the available pool of indigenous talent.

Foreign direct investment can play a positive role in stimulating competition in the host economy, thereby leading to significant improvements in productivity. In fact, the entry of a truncated foreign subsidiary may be the only economic means of providing competition in situations where undertaking fully integrated activity in Canada is simply not feasible. Conversely, in cases where the distinctiveness associated with a particular foreign direct investment effectively precludes the emergence of domestic competition, such investment may have undesirable side effects on that industry and its productivity. A foreign investment of this nature may lock the Canadian economy into a relationship with a foreign firm for a longer period than is justified by the firm's contribution to productivity. Alternatively, it may

stultify the development of competing Canadian suppliers for various inputs, such as engineering services, by tying in the other inputs of the foreign firm to the distinctive parts of its investment package. Foreign takeovers of Canadian controlled firms are more likely to have an adverse impact on competition than new foreign investment.

While technology and management can be significantly upgraded through foreign direct investment, especially in the short run, its impact on the longer run development of indigenous capabilities raises a much more complex question. In the final analysis, improvements in managerial competence and in the ability of the nation to generate technological breakthroughs depend to a large extent upon the nature of the overall social and economic environment. To the extent that foreign direct investment is relied upon to improve productivity, it may result in stultifying the development of indigenous capacities. This danger exists because improvements in technology and managerial abilities frequently involve a "learning curve" process, with new achievements being built on past accomplishments. Accordingly, dependence upon foreign technological and managerial inputs can tend to become self-perpetuating.

It is apparent, therefore, that advances in productivity are closely related to a number of other factors discussed in this chapter. Increasing productivity is crucially important for the achievement of a satisfactory rate of economic growth and for the creation of adequate employment opportunities, both quantitatively and qualitatively. Some degree of indigenous capacity to improve productivity is also important in order that Canada may have sufficient know-how to shop around for the best technology available at the most reasonable cost and to enhance domestic control of the economic environment by reducing dependency on foreign technology. The main objective of public policy should be to establish a mix that will continue to allow Canada to draw upon techniques and technology developed abroad that will help to improve Canadian productivity, while at the same time stimulating Canada's capacity to develop its own.

Foreign Direct Investment and Income Distribution

Foreign direct investment often contributes to increases in the productive capacity of Canadian labour and to the extent that this is so, there will be a tendancy for such productivity advances to be translated into higher wages and salaries. Moreover, in cases where foreign direct investment results in additions to the overall level of economic activity, the demand for labour in supporting industries will be increased—both directly and indirectly—thereby tending to push wage and income levels upward.

On the other hand, where foreign direct investment is particularly capital intensive in nature, as has been the case in many resource extraction and processing industries, labour's share of the value added may be relatively small in comparison with that enjoyed by the owners of capital. Where foreign direct investment of a capital-intensive nature replaces more labour-intensive

means of production, the demand for labour may be adversely affected. Truncation may also mean a relatively lower level of demand for labour—both directly by the firm in question and indirectly in supporting industries—than would be the case in a more complete subsidiary operation, or one which is more rationalized internationally.

By providing stimulus to the competitive atmosphere in a particular industry, foreign direct investment may result in downward pressure on prices and profits. The net result in such a case would be to distribute greater benefits to labour through reductions in the prices of goods and services, to supporting industry through the stimulation of economic activity generally, and to the buying public. However, where foreign direct investment is essentially anti-competitive in its impact, it may redound to the disadvantage of labour, domestic supporting industry and consumers. It will also tend to allow a higher level of profits than might otherwise be the case.

Ways in Which Foreign Direct Investment Affects Tax Revenues

The tax revenues of the host economy may be significantly increased by the activities of foreign direct investors. Where such investment contributes to an increase in the general level of business activity, a portion of this increase will normally accrue through taxation to the host government, at least over a period of time. It may also provide employment, thereby contributing to a general increase in wage and salaries, which further expand tax revenues. Moreover, to the extent that improvements in technology associated with foreign direct investment enhance productivity, they will enable the subsidiary to pay increased wages or earn increased profits—or both, which would further augment to revenues.

Foreign direct investment also offers opportunities for resorting to various "tax avoidance" techniques, most notably transfer pricing techniques involving inflated or artificial payments to the parent firm for various goods and services. The foreign controlled firm will generally find it easier than the Canadian controlled firm to reduce the payments of certain taxes primarily because of the international nature of its business affiliations. Dealing with this is a problem involving the application of Canadian tax law.

Foreign Direct Investment and the Competitive Environment

Foreign direct investment has, in some cases, significantly enhanced the competitive environment in particular industrial sectors. The stimulus provided by entrepreneurially aggressive and internationally efficient manufacturing firms can induce competing indigenous industrial concerns to innovate and achieve higher standards of efficiency.

On the other hand, foreign direct investment has contributed to a significant reduction in competition in those industries characterized in-

ternationally by oligopolistic structures. This reduction in competition would tend to have an adverse impact upon prices, and permit companies in such industries to earn higher profits than they might otherwise have been able to do. It may also have made it more difficult for new domestic and foreign firms to enter the industry.

This is not to suggest that foreign direct investment alone has shaped the Canadian competitive environment. A protectionist tariff policy, along with a relatively limited domestic competition policy, has undoubtedly helped to contribute to the same result. However, a significant proportion of the anti-competitive impact of foreign direct investment must be related either to the market power of some foreign investors, which may be either rooted in or reinforced by their distinctiveness, or to the lack of competitiveness in the international market. These anti-competitive factors reduce the scope for domestic policy action.

Shortcomings in the functioning of the competitive market system affect performances in all facets of the industrial process. As a result, economic growth, the creation of employment opportunities, and efforts designed to achieve a more equitable distribution of the nation's output, may all suffer. Some improvement may be achieved through the application of a more effective domestic competition policy. But other aspects should also be tackled through intergovernmental agreement because much of it is international in scope and beyond Canada's ability to deal with it alone.

Impact of Foreign Direct Investment on the Nature of Canadian Industrial Activities

Various factors influence the Canadian industrial mix, including domestic economic policies, the size of the domestic market, Canadian tastes and the Canadian resource base. Foreign direct investment is a further factor.

In general, foreign direct investment seems to have led to more natural resource extraction in Canada than would have been the case in the absence of foreign direct investment. Foreign direct investment seems also to have affected the distribution of industrial activity within the manufacturing industries. The discussion below will look first at the distribution between natural resources and manufacturing.

It is possible that a substantial part of the resource extraction which has occurred in Canada would have taken place even in the absence of foreign direct investment. The availability of large export markets might have led Canadian businessmen, possibly with the assistance of foreign debt financing and long-term sales contracts, to carry out many of the projects which have been carried out by foreign direct investors.

At the same time, it seems equally clear that other resource projects which have proceeded in Canada would not have done so if foreign direct investment had not been available, or if its entry had been restricted by the Canadian government. Many foreign investors in Canadian resources are firms that operate large processing, fabricating and manufacturing facilities

abroad—or some combination of such facilities. These investors have looked to Canada and other resource-rich countries for secure supplies of raw material or partly processed raw materials to feed their facilities. They prefer to own and control the natural resources which are to be used in their plants at home. If they had been prevented from making direct investments in Canada, some of them would have looked outside of Canada for raw materials, rather than enter into arrangements to purchase them at arm's length from Canadian firms. The attitude of the foreigner in such cases would likely depend on a variety of factors, including the extent to which the resource was available elsewhere in the world, the political stability in each country where it was available, and the cost involved in extracting from the other jurisdictions as compared to Canada. But some Canadian resource extraction almost certainly would not have proceeded.

Secondly, in the absence of foreign direct investment, a certain amount of resource extraction in Canada would probably not have taken place because of the lack of Canadian entrepreneurs to put together the necessary package—capital, markets, technology, and other skills. Some of the more costly projects, in particular, might not have proceeded because of the risks involved.

The large volume of Canadian resource output that is neither processed, fabricated nor manufactured in this country, is not only a result of the policies of foreign investors, but is also a result of the policies of their home governments. Tax concessions are sometimes granted by the home government on resource development abroad and the imported raw materials subsequently granted duty-free entry, in contrast to the relatively high duties imposed on imports of goods entering the home country in more processed form. These factors together provide a strong inducement to the foreign investor to look to resource-rich countries such as Canada as places from which to obtain raw materials only.

They have no particular disposition on their own to undertake any greater degree of further processing in Canada than is needed to obtain access to the raw material in its most economic form unless the economic advantages of additional processing in Canada become very persuasive.

Canadian policy should aim at a balance between the development of resources and other sectors of the economy. Resource extraction is a capital-intensive business and generates few jobs directly. While the resource sector does help to generate other jobs indirectly, it could make a greater contribution to employment if more processing of resources were undertaken in this country.

There are practical limitations on the extent to which Canada can specialize in resource extraction. Theoretically, it might be argued that if insufficient employment were generated by resource extraction, the market forces would cause Canada's wage rates to become relatively lower than those of its major competitors and, as a result, cause a shift in manufacturing activity to this country from abroad. It is questionable, however, whether

this chain of events would take place in practice. For one thing, institutional links between markets in Canada and the United States would retard any widening of the wage differential between the two countries. Moreover, some Canadian workers might emigrate in search of better opportunities elsewhere before new employment opportunities began to develop in Canada. It is important to recognize also that other countries with much lower wages than Canada already act as a magnet for manufacturing activity. In other words, there may well be practical problems in maintaining full employment for the present and future Canadian labour force if Canada concentrates too heavily on resource development at the expense of the development of its secondary manufacturing and service industries.

There are other dangers in excessive concentration on natural resource extraction. The demand for natural resources tends to be somewhat cyclical. Relatively small changes in demand for finished products can reverberate backward through the distribution chain, causing very sharp increases or decreases in demand for raw materials. As a result, Canadian output of and/or prices for natural resources can fluctuate very sharply, producing considerable instability in the economy generally and in the small towns which are heavily dependent on a given resource industry, in particular.

These factors are especially important in the context of the large demand, anticipated for natural resources from the United States, Japan and the expanded European Economic Community during the 1970's, considering the continued growth of the Canadian labour force expected over the course of the decade. While additional research is undoubtedly needed on the job-generating impact of natural resource extraction, it would seem—even with the current state of knowledge—that resource development must be kept in balance with that of other sectors of the economy to ensure that the expansion of employment opportunities is in line with the expansion of the labour force.

The mix within the manufacturing sector is also affected by foreign direct investment. There is a large demand in Canada for goods of foreign origin. In order to get a portion of the production of these goods in Canada, Canadian policies seek to create a cost advantage for the foreigner in locating at least a portion of his production activity in Canada, mainly through the use of tariffs, grants and loans.

Canada is never likely to develop and produce indigenously all or most of the manufactured goods desired by Canadians. It seems natural, and makes good economic sense, that some Canadian manufacturing activities will be carried out by foreign controlled subsidiaries or by Canadian controlled firms under licence from foreign manufacturers, and thus based upon foreign technology and know-how.

There are certain products which would probably never be made in Canada if it were not for foreign direct investment. Among these are the items for which research and development costs are very high. Canada may at times seek on a selective basis to develop a capability in a few such prod-

ucts; and it is occasionally possible to obtain them on licence. But in many cases Canada would have to import such products in the absence of foreign direct investment.

In practice, this means that Canada's industrial mix is influenced significantly by the kind of products generated in the United States. Canadian demand for foreign goods is heavily influenced by Canada's proximity to the United States and by the advertising and cultural spill-over from the United States, which play a large role in shaping Canadian tastes.

The items Canada obtains from the United States that cannot be developed indigenously may frequently be the outcome of heavy United States research and development expenditures, a large proportion of them related to past United States defence and space programmes.

In the absence of foreign direct investment, Canada could not afford to produce many of these items because of the costs of research and development. In the case of other products, the existing economies of scale might dictate the manufacture in Canada of far fewer models. Without the ready availability of United States direct investment, therefore, the Canadian manufacturing mix might be substantially different. Greater attention might be focused on products developed elsewhere in the world beyond the United States that could be produced economically in this country. Direct investment, therefore, provides a vehicle for influencing the mix of products made in Canada and those imported.

The Relationship Between Foreign Direct Investment and Gaps in the Canadian Economy

The provision of large pools of capital, new technology or management skills by foreign direct investors can compensate for gaps in the ability of Canadians to undertake industrial activity on their own. It can lead to the establishment of activity in Canada which would not otherwise be undertaken here. It can free Canadian resources for alternative uses in which they can be more efficiently employed. In short, it can increase Canadian productivity and real incomes, as well as enhance the diversity of choices available to Canadian users and consumers.

The filling of gaps through foreign inputs may reflect sound resource allocation based on international specialization and the existing economies of scale. Obtaining the needed input through foreign direct investment may be the cheapest source for the Canadian economy, and the resultant truncation may be entirely rational in economic terms.

Conversely, however, foreign investment may result in increased costs being imposed on the Canadian economy. This can occur in four basic ways. The foreigner may be able to charge the Canadian economy more than the input is reasonably worth (or more than an alternative procurement source), drawing an excessive return in a variety of ways, such as dividends, interest payments, management fees or royalties. He could increase the cost to the

Canadian economy by imposing restrictions on export markets. He could also increase the cost by tying inputs into his investment package which the Canadian economy could provide more cheaply. Lastly, the foreign investor may help to perpetuate the gaps in the economy by stultifying the development of Canadian capabilities to fill them because he is unlikely to develop the capacities in Canada to undertake those functions that are performed abroad by the foreign parent.

The possible stultification of Canadian capabilities by foreign direct investment raises difficult questions for public policy, since it is not easy to determine to what extent foreign direct investment is the cause of these gaps and to what extent it is the result of them. The general business environment, which is in part shaped by general economic policies and the behaviour of existing institutions, also contributes to the existence of gaps. Furthermore, the use of foreign direct investment to fill gaps may be an economically rational course of action at the time an investment is made. This situation can change with the development of Canadian capabilities, however, but Canada could find itself locked into an investment which no longer provides an overall benefit to the economy. In other words, an investment which initially involved rational resource allocation can over time become inefficient and stultify the development of potentially more efficient Canadian capacities.

Despite these difficulties, Canada needs to develop more of its inputs indigenously. The filling of gaps in the economy and the provision of more inputs from domestic sources should reduce the degree of dependence of Canadian industry on foreign direct investment and, in turn, the degree of truncation such investment need involve. Improving Canada's capacity to provide more inputs does not appear to be an impossible goal. In some cases, the essential requirement is the will and determination to develop them, reinforced by the appropriate modifications in public policy—and in some cases by the provision of public funds—to get things going. In launching such an effort, however, it would be important for Canada to concentrate on developing only those capacities that it can undertake economically.

In considering how to fill the existing gaps, it is important to remember that indigenous development or foreign direct investment are not the only alternatives. The possibilities of licensing arrangements, joint ventures or direct importation should also be borne in mind, particularly because Canada cannot expect to become self-sufficient in all lines of production.

Foreign Direct Investment and Domestic Control of the National Economic Environment

A national objective of overriding importance for Canada is the maintenance of national sovereignty and independence. This relates not only to the continued existence of the nation as a distinct political entity, but also to Canada's ability to effectively determine its own social and economic priorities and shape the nature of its economic activities.

Foreign direct investment weakens domestic control in the following ways: it increases the exposure of the Canadian economy to decisions taken outside of Canada which can have a distruptive effect on the Canadian economy; it complicates, and at times may frustrate, domestic policies aimed at creating a more efficient economy by acting as the vehicle through which distortions in the international markets are transmitted to the Canadian market; it complicates and at times may frustrate domestic policies aimed at a more efficient economy; it occasionally acts as a vehicle for the extraterritorial application of foreign law and policy in Canada and, less frequently, as the *raison d'être* for foreign governments to attempt to bring pressure to bear on the Canadian government. Finally, it can complicate and frustrate enforcement of domestic law.

Taking the foregoing points in order, Canada, in the first place, is very much an "open" nation, especially in matters of international trade and investment. While this openness can in some cases contribute to an efficient allocation of international resources (despite the numerous shortcomings noted earlier) and in those cases confers upon Canada the concomitant benefits of this resource allocation process, at the same time it also increases the nation's vulnerability to external forces. In matters of trade, Canada can be injured by sudden and arbitrary actions of its trading partners. This threat is reduced by the rules and regulations of the General Agreement on Tariffs and Trade (GATT), although in exchange Canada has surrendered some of its freedom to act independently in matters of trade.

In matters of foreign direct investment Canada is, if anything, even more vulnerable, being exposed not only to the policies of foreign governments, but also to the decisions of international corporations. There is no set of rules regulating government behaviour with respect to international investment such as the GATT provides with respect to trade. Moreover, there exists no internationally agreed rules governing relations between host governments and foreign firms operating in their jurisdiction. If a firm has the economic or political clout to challenge a host country, there is no internationally recognized forum to which the host government can appeal. Therefore, as an economy becomes more heavily dependent on foreign direct investment, it is correspondingly more exposed to the arbitrary actions of those who are largely outside its jurisdiction. This is an important limitation on domestic control of the economic environment.

Furthermore, firms with production activities in many jurisdictions may be able to play off one host country against the other in improving their terms of access to these countries, and in Canada they may also be able to play off one province against another. This complicates Canada's problem in developing policies to meet domestic needs, in that the mobility of international business may enable them to escape the impact of such policies.

Secondly, foreign direct investment can serve as the instrument through which the various distortions generated by the international market-place are transmitted to Canada and, in the process, contribute to a domestic industrial

structure which may not accord with Canada's needs. The Canadian government's control over these problems of industrial structure can be frustrated or made more complex by the international links of the foreign subsidiaries in Canada and the international nature of the distortions.

For instance, the fact that many Canadian firms are subsidiaries of foreign manufacturing companies limits the ability of the federal government to implement a policy of industrial rationalization. And in seeking to convince parent firms to ease restrictions on exports, it may find that means are not readily at its disposal for achieving such objectives.

Similarly, a foreign direct investment by large international firms can have a significant impact on the industrial priorities formulated by the nation. In Canada, there is the danger of over-developing resource extraction in comparison with other sectors. In this connection, the attitude of foreign investors in natural resources can be heavily influenced by the committed investment of these firms in fabricating and manufacturing facilities at home and by home government import restrictions, thus standing in the way of Canadian efforts to achieve further processing in Canada. The key point here is that foreign fabricating and manufacturing firms which integrate vertically backwards to obtain secure supplies of natural resources are less likely to respond to Canadian needs and economic capabilities as their *raison d'être* is shaped heavily by their committed investment elsewhere.

This is not to suggest that a different mix of domestic policies in unimportant in dealing with such distortions. But, as will be discussed more fully later,[4] domestic policy instruments now available can only get at those economic distortions which are rooted in Canada, not those rooted abroad.

Thirdly, foreign direct investment has served as a principal instrument through which foreign governments—particularly the United States government—has on occasion extended the application of some of its trade, anti-trust and balance of payments policies to Canada. While these manifestations of extraterritoriality have not created major economic or social problems for Canada up to now, they have represented an intrusion of foreign law and foreign government policy into Canada and in that sense constituted a challenge to Canadian sovereignty.

There have also been one or two changes in the substance of public policy in Canada owing to the representations of foreign governments to the Canadian government to protect the investments of their nationals. While such interventions are understandable, they do constitute a further pressure affecting the way in which the Canadian government determines certain domestic policies; and this is a factor which would not exist in the absence of foreign direct investment.

Lastly, foreign controlled subsidiaries in Canada have a greater capacity to frustrate Canadian laws than do domestic firms. The international links of such firms give them greater capacity to avoid payment of taxes in Canada. And they may also find it easier to circumvent competition legislation.

[4] See below under "Implications for Public Policy".

Impact of Foreign Direct Investment on Canadian Culture

It is difficult to isolate the impact of any single influence (such as foreign direct investment) on the nation's culture and identity. This is especially true in the case of an open society such as Canada, where a wide variety of influence has shaped its culture and way of life. It is difficult, for example, to distinguish between those aspects of Canadian social and cultural development which emanate from the general pattern of industrial, technological and economic development, and those which can be more directly identified as foreign imports. It is equally difficult, for example, to separate the importance of a high degree of United States control of Canadian business from the impact of a common language, the mass media, a similar political tradition, the use of the same texts at universities and public schools, trade, travel, common professional associations and trade unions, and close family and friendship links.

Foreign direct investment affects Canadian culture more directly through foreign corporate ownership of Canadian subsidiaries in cultural industries, such as book and periodical publishing and film distribution. More generally, the influence of foreign direct investment is reflected in the emphasis on continuing advances in technology and rapid product turnover. It is, for example, not unusual for a foreign controlled firm to produce and market products developed by the parent concern and to employ the same methods as the parent in such matters as labour relations, advertising, relations with government, and so on. The result is that such products and operations frequently tend to reflect the tastes, life-styles and habits of the foreign nation involved. In this regard, one fact of overwhelming importance is that so much of our foreign direct investment comes from one nation. This has particularly important implications—especially in the longer run—for the nature of future Canadian growth and development, since the political and economic strength of a nation consists largely in its ability to create a distinctive cultural, social and political milieu which fosters indigenous initiative and innovation.

Canadian society can be enriched by the variety and diversity of products offered through direct investment. And the development of a Canadian nation with a distinctive indigenous culture will depend, in the main, on the encouragement of domestic talent and creative capabilities, rather than on the erection of barriers to foreign influence.

But it must also be recognized that the creation and development of such Canadian capacities can be stifled if Canada is inundated with influences from other countries which are much larger or much more developed than Canada. The large volumes of United States direct investment in Canada constitute an important part of the massive American influence on Canadian society, although certainly not the largest portion of it. Prohibiting further United States investment would by no means ensure the emergence of a viable and attractive Canadian culture. Some further capacity to con-

trol such investment, however, may contribute to the creation of a strong national identity and a stimulating and distinctive culture.

THE BENEFITS AND COSTS OF FOREIGN DIRECT INVESTMENT

The discussion above focused on certain national objectives (e.g., growth, sovereignty, "quality of life", etc.) and suggested that foreign direct investment involves both benefits and costs in terms of the nation's ability to achieve these objectives. If foreign direct investment were to involve only costs, a clear case could be made for banning it altogether. But foreign direct investment has in the past played, and continues to play, an important role in Canada's economic development. Therefore, any sweeping arbitrary prohibitions would be bound to involve a substantial economic price.

The "distinctiveness" normally associated with foreign direct investment represents something which is desired by Canadians. To the extent that the foreign investor is able to extract a high return on his distinctiveness, however, foreign direct investment may be an excessively costly means of acquiring this distinctiveness.

It has been suggested that foreign direct investment may have either a positive or a negative impact upon the overall level of Canadian economic activity, productivity, wage levels, and so on, depending upon the nature of the investment and the terms and conditions under which it takes place. Restrictions on the freedom of the subsidiary to carry out normal business functions independently of the foreign parent may represent significant economic costs—especially in regard to longer term considerations because these restrictions outweigh any benefits provided by the investment, or because they reduce the net benefits which could be obtained from the investment.

Similarly, the extraction of very high profits may be costly to the economy, but still the cheapest way of getting the foreign input. In many cases, however, it may involve payment of a higher price by the economy than is necessary to acquire that input.

Each individual foreign direct investment, as well as foreign direct investment in the aggregate, involves a mix of benefits and costs. There may be scope for reducing the costs and increasing the benefits to Canada in particular cases where the foreign firm is prepared to settle for a lower return than that now available—albeit reluctantly—without being deterred from undertaking a new investment in this country or maintaining his present one. Even if the investor is obtaining only the minimal return needed to keep him in Canada, he may be willing to change his behaviour where his interests and those of the economy coincide and where both the investor and economy can benefit from some new arrangement.

IMPLICATIONS FOR PUBLIC POLICY

The remainder of this chapter assesses the implications for public policy which flow from the foregoing conclusions about the nature and impact of foreign direct investment that have emerged from this study. Before setting out these implications, it is important to repeat some of the main policy considerations noted at the outset. Any policy on foreign investment must take account of the need for a satisfactory rate of economic growth, adequate employment opportunities and continuing improvements in the living standards of the 22 million people in Canada. To achieve this, it must recognize the need for industrial efficiency, which requires that Canada be able to get access to the best in world technology and management systems. And in achieving these aims, policy must acknowledge the differing needs of the various regions of the country and the political and constitutional realities which shape relations between the federal and provincial governments.

The main implications for public policy which emerge from the conclusions above are that:

(i) there are costs and benefits from foreign direct investment and improvements in the net benefits are possible (Consideration should be given to a change in the mix of public policy to improve the net benefits in view of the broad objectives of the nation noted earlier with respect to the future of the Canadian society and economy.);

(ii) some of these objectives can be advanced through a change in the mix of general economic policies—including tariff policy, competition policy, tax policy and patent policy—aimed at improving the efficiency of the economy as a whole;

(iii) other objectives can be advanced through measures aimed at strengthening particular domestic capabilities—in capital markets, technology, management, and, more generally, in entrepreneurship;

(iv) important problems would remain even if all the changes just touched on involving general and particular economic measures were implemented, with the result that additional policy initiatives need to be considered;

(v) policy initiatives providing for Canadian ownership across all or large parts of the economy would not remove most of the important remaining problems, nor would they advance the broad objectives of the government and people of this country;

(vi) a more effective means of dealing with remaining problems of foreign direct investment would be through flexible administrative intervention on a case-by-case basis;

(vii) such intervention can justifiably be restricted to foreign controlled firms; and

(viii) administrative intervention would be most effective if carried out within the framework of well-defined industrial strategy.

NEED FOR A CHANGE IN THE MIX OF PUBLIC POLICY

As already noted, foreign direct investment can bring both benefits and costs to Canada. In those cases in which foreign direct investment brings net costs to Canada, it may be possible through changes in public policy to alter the distribution of the benefits and costs between the Canadian economy, the home economy, and the investor, in order to produce a net benefit for Canada. In other cases, where there is a net benefit to Canada to begin with, it may be possible to increase the benefit through a change in public policy. The possibility of influencing the distribution of benefits to the advantage of the Canadian economy in part reflects the fact that there is often a range of returns over which it may be attractive for the foreigner to invest in Canada. The foreigner who wants Canadian natural resources, for example, may be able to secure them under conditions which fail to provide an adequate return to the economy—a return that he may well be prepared to provide if pressed to do so—in terms of generating new economic activity in Canada, perhaps through additional processing. In manufacturing, the foreigner may want access to Canada for his distinctiveness, but the economy may be paying a higher price than is necessary to acquire it. Once again, the nation may be able to require a greater contribution to economic activity or other benefits in return for granting the right of access to the foreigner.

Much foreign direct investment in manufacturing is characterized by inefficiencies, particularly in the miniature branch plant replica. While many foreign subsidiaries are important to the economy, the extent to which they are truncated often reduces their potential for generating greater economic activity in Canada. A prime example is to be found in the relatively low level of processing in this country of Canadian natural resources extracted by foreign investors and shipped abroad for processing in their plants abroad. The stultification of domestic capacities and the possibility of unbalanced development of the resource sector are other serious problems posed by foreign direct investment. Together, they indicate that a change in public policy is required.

Any change in public policy, however, must recognize that important benefits have been and can continue to be obtained from foreign direct investment. Therefore, public policy must grapple with the need to improve the benefit-to-cost ratio from foreign direct investment for Canadians.

Apart from the economic impact, other problems can also arise from foreign direct investment, including those resulting from the extraterritorial application of foreign law in Canada, the narrowing of policy options open to Canada in certain policy areas discussed earlier, and the impact on the

development of Canadian culture in the face of such vast amounts of foreign direct investment from a single country. Public policy must also reckon with these non-economic considerations.

THE ROLE OF GENERAL ECONOMIC POLICIES

Many of the industrial problems associated with foreign direct investment referred to previously are due in some measure to general economic policies. The inefficiencies associated with the miniature branch plant replica and the widespread truncation of Canadian manufacturing are in part a result of the general economic environment—both in Canada and abroad—and the general economic policies which contribute to it. Similarly, the danger that the balance in the structure of the economy may be distorted by excessive resource development, or in other ways, is in part also attributable to general economic policies in Canada and abroad. Gaps in indigenous capabilities further influence the way in which the manufacturing and resource sectors are developed.

The miniature branch plant replica has been largely the result of high tariff policies in the past, which were designed originally to help establish industrial base and adequate job opportunities in Canada. High tariffs were accompanied by a limited competition policy. Together they helped make it profitable for manufacturing subsidiaries to turn out duplicates of much of the foreign parent's product line for sale in Canada, but at higher prices than Canadians would have had to incur if imports had been allowed to enter the Canadian market with the payment of little or no duty. If there were a more competitive environment in future, brought about at least in part through lower tariffs, pressures would be created for greater rationalization of the production of Canadian industry. The objective would be to reduce costs by achieving the economies of larger scale production in order to better meet international competition at home and abroad[5].

An approach of this nature could only be adopted over a period of time to make possible the adjustments required to safeguard employment opportunities. Therefore, it is unrealistic to expect large and rapid tariff reductions as a general federal approach, particularly if such a policy did not form part of the framework of a wider industrial strategy involving the federal government in helping to develop and to support areas of efficient Canadian production. Under such an approach, federal support (through tax incentives, loans, subsidies or government procurement contracts, or some combination of these) would be directed to particular industries or lines of

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[5] While the comparatively low level of productivity of foreign controlled Canadian manufacturing firms is partly explicable by general economic policies, it must also be recognized that these firms are partly responsible for the current situation. In many cases they have located in Canada in large part because of the shelter of the tariff; and having done that, they have exerted pressure to maintain this protection. These firms have seldom taken the initiative in intra-firm rationalization across international borders. If the cost structure of Canadian industry is high, it is in part due to high cost manufacturing of foreign controlled subsidiaries. It tends, in other words, to be a kind of vicious circle.

production in which Canada has realistic possibilities of developing and retaining competitive strength internationally (or, occasionally, for industries being developed to satisfy such non-economic objectives as cultural development). At the same time, other lines of production would contract under the pressure of market forces, their place being taken by imports. An approach involving lower tariffs and a competition policy based on promoting industrial efficiency and greater rationalization of production could be integral components in any new thrust of general economic policy that might be considered by the federal government for the future. Consideration might be given also to providing assistance to companies and workers where necessary to facilitate the process of adjustment.

Such an approach is consistent with the present direction of federal policy. Tariffs have been lowered gradually since World War II. The government has stated its intention of proposing to Parliament the adoption of a more vigorous competition law consistent with this kind of industrial rationalization. Past federal initiatives have already encouraged rationalization in certain industries. The government has also spoken of the need to further develop, define and articulate on industrial strategy for Canada appropriate to present circumstances.

To be successful in this approach, it would be highly desirable to encourage innovation in this country to enable Canada to generate the distinctive products in which it can specialize. It would also be necessary to continue to improve the terms of access for Canadian exports in foreign markets.

Emphasis has already been placed on the need to improve the net benefits from foreign direct investment in Canada—to set policies that will require it to operate in a more competitive environment, to reduce truncation and to do more to improve the efficiency of Canadian industry. Without an efficient and internationally competitive economy, for example, it would not be possible to bring about an increase in exports by subsidiaries. If the Canadian government puts pressure on an MNE to remove or reduce the export restrictions it has imposed on its subsidiary, the effort will produce no results—assuming the MNE is willing to be cooperative—if costs in this country are too high to permit even the large scale production of a particular product by the Canadian subsidiary to meet international competition abroad. By the same token, pressing subsidiaries to acquire more components and services will have little effect if Canadian costs are out of line with those elsewhere. This results from the fact that subsidiaries in Canada that employed high cost Canadian-made components and services would be unable to meet existing import competition without a further increase in tariff protection.

Similarly, a competitive and efficient industrial structure is a necessary condition for stimulating innovation. Under strong market forces, firms have to be constantly looking to new products and technologies to stay ahead of their competitors.

Other aspects of public policy also have a bearing on the competitiveness of Canadian industry. Canada is very heavily dependent on foreign technology, much of which is patented. Patents are restrictive devices and protect the owners of the patent at the expense of the users of the product or process. Many patents are for industrial components and machinery, thus increasing the costs of Canadian production. Patented consumer goods tend to impose higher prices on consumers. If Canadian patent laws were less restrictive, Canadians would be able to obtain foreign technology, and the benefits of such technology more readily and more cheaply. Such a change should improve the cost structure and competitiveness of domestic industry and benefit Canadian consumers.

Tax policy and industrial incentives are of great importance in determining the industrial mix of the economy. To the extent that Canada wishes to ensure a proper balance between the manufacturing and resource extraction sectors, consideration must continue to be given to the relative tax burden and industrial incentives available in the various sectors of the economy in light of changing circumstances both at home and abroad.

Tax, commercial and industrial development policies are all important in shaping the general environment. Policies in these three areas must reflect some of the overriding requirements of the economy: an adequate flow of savings, improved industrial management, more indigenous technology and dynamic and creative entrepreneurship.

Specific measures can also be appropriate in dealing with particular problems arising from foreign direct investment. The way the law is administered can minimize problems arising out of unfair transfer pricing, for example. Immigration and manpower policy can perhaps be more directed to attracting the specific kinds of talent needed to fill some of the gaps in domestic capacities. And international discussions, multilaterally and bilaterally, may help deal with problems that cannot be fully resolved through domestic policies alone.

In summary, general economic policies are important instruments for improving the net economic benefits obtained from foreign direct investment.

POLICIES TO STRENGHTEN INDIGENOUS CANADIAN CAPABILITIES

Improvements in general economic measures could be reinforced by the development of complementary policies aimed at remedying specific weaknesses or gaps in Canadian capabilities. Consideration could be given to measures designed to encourage the capital pooling and entrepreneurial capabilities of the financial institutions. The kind of measures which might be helpful include those aimed at increasing the proportion of high risk and entrepreneurial financing carried out through domestic financial institutions. Steps which would increase the liquidity of the Canadian stock markets or increase the capital available to the more entrepreneurial parts of the financial industry might be particularly helpful. Similarly, policy changes which would

augment the domestic sources of development capital and the competition between these sources should prove beneficial. Consideration might also be given to the possibility of providing incentives to encourage a more entrepreneurial attitude by existing financial institutions, to stimulate the creation of new pools of capital and to further expand the financing role of the federal government. More detail on the various options were set out earlier.[6]

Secondly, government measures should be considered to reduce Canada's dependence on foreign technology. In part, this may require giving more careful consideration to the possibility of awarding large government contracts involving heavy research and development expenditures to Canadian controlled firms under carefully defined circumstances. But even with more indigenous technology, Canadians would remain very dependent on foreign technology. This suggests that need for consideration of methods to improve Canada's capacity to buy the most suitable foreign technology at the lowest possible price to adapt to Canada's industrial needs.[7]

More generally, measures which would enhance Canada's industrial management capability and stimulate creative entrepreneurship would be helpful, as was discussed in Chapter Nine. In general, greater domestic capabilities would tend to lead to more Canadian controlled enterprises, thus increasing the net benefits which Canadians are able to obtain from foreign direct investment.

THE NEED FOR NEW APPROACHES TO PROBLEMS ARISING FROM THE INTERNATIONAL MARKET PLACE

Revisions to general economic policy and for specific measures to strengthen indigenous Canadian capabilities are required if the policy objectives described earlier in this study are to be achieved. Indeed, where the problems of economic development are created by the domestic economic environment, changes in general economic policies may be sufficient to deal with them. But where problems are rooted outside of Canada, such policies are not likely to be sufficient to get at the source of the difficulty.

If implemented, the policy measures considered at various points in this study should help Canadians to develop the capacity to undertake more of their own industrial activity. They would enhance domestic control of the economy. Most of these policies likely are worth undertaking on their own merits for reasons of economic development. These measures can also help to increase the benefits from foreign investment. They can help create a healthier industrial structure and environment, allowing more of the benefits of foreign direct investment to be retained in Canada. For example, they can result in less fragmentation of industry, accelerate the rate of dissemination of imported technology and facilitate financing of Canadian industrial activity.

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[6] See Chapter Seven.
[7] See Chapter Eight.

These domestic economic policies will not, however, get at the imperfections of the international market place in allocating industrial activity. These were discussed earlier. They will not deal with the phenomenon of market power which is rooted outside of Canada. They will not offset the interventions of other governments in influencing corporate decisions regarding trade and the location of production. Nor will they overcome the distortions of the international market place that result from the very nature of the new institution that has assumed such an important role on the world stage, the MNE.

There are further reasons for contemplating additional measures to deal with the problems posed by foreign direct investment. Even if the general policy measures suggested for consideration were adopted by the federal government, they would likely take a period of years to implement, however, because most of these general policies are aimed at satisfying a variety of public objectives and require additional study on the technical problems of implementing them.

There is a further factor closely related to the above point. While it is sometimes argued that in the very long run domestic and international markets will do a reasonable job in allocating resources, it is questionable whether the Canadian government can simply stand by and wait for this natural process of adjustments to work itself out—assuming that it will. Rather, additional measures are necessary to ensure that international market imperfections do not frustrate the achievement of national objectives in the short and medium term.

Finally even though the logic of this analysis generally argues against an across-the-board protectionist approach, some measure of protection for Canadian management may turn out to be desirable in particular situations. The kinds of general policy options outlined above do not provide the kind of instrument which would enable this form of selective protectionism to be provided.

RELEVANCE OF CANADIAN CONTROL OF BUSINESS

The available evidence does not suggest, however, that these additional measures should be based mainly upon legislation requiring Canadian ownership and control of all Canadian business firms. To the contrary, the data comparing the performance of Canadian controlled firms to foreign controlled firms indicate that Canadian control of a business is not in itself a guarantee of sound performance and is not, therefore, a satisfactory means for achieving Canada's broad national objectives. For instance, general legislation providing for 50 or 51 per cent Canadian ownership, either in the economy as a whole or in particular industries, can be very costly to the economy[8]. Across-the-board ownership rules create the risk, even in industries where there is good reason to prefer Canadian ownership and

[8] See Chapter Twenty Six.

control, that Canadian management would be cut off from the market pressures if the Canadian ownership restrictions were too rigid. Such provisions can serve as a barrier to the introduction of new technology and management systems.

In this connection, it is important to recognize also that Canadian based multinational enterprises are not, by themselves, the answer to the problems posed by foreign direct investment in Canada. Canadian based MNE's can be heavily influenced by their major foreign markets. This can lead them to truncate their operations in Canada, locating some of their more important activities in the countries in which their larger markets are located. And even if Canada had many more Canadian based MNE's, they would not constitute a response to the problem posed by foreign direct investment in this country.

But Canadian control can be important in some cases. The competitive ability and market power of multinational corporations suggest that—notwithstanding the limitations noted above—it would be to Canada's advantage to foster the development of Canadian multinational companies, at least in some of those sectors where internationalization is occurring and where Canada has a comparative advantage. The alternatives would be to have more foreign branch plants of multinational companies operating in Canada in these industries, or to shut out multinationals altogether, thereby denying Canada the efficiencies which multinational corporations can generate in some cases, such as lower costs, increased competition and greater technological development.

It is more likely that a Canadian controlled firm, including a Canadian based MNE, will tend to more bias toward locating activity in Canada than will a foreign controlled firm, which can be helpful in rooting technology and production in this country.

Canadian control may also be important in particular sectors which the government consciously seeks to develop. If the government provides large grants to a firm, or awards it a large contract, the government will want to maximize the possibility that the Canadian economy will get the appropriate industrial benefits. The capacity to influence the activities of such firms in order to ensure such a result tends to be greatest when the firms are Canadian controlled.

Some Canadian control of Canadian business firms is also necessary to ensure that entrepreneurial and innovative environment in Canada is improved. If all large firms in Canada are seriously truncated, there will be few suitable jobs for Canada's most able and creative people. They will tend to emigrate. Innovation in Canada will thus be correspondingly more difficult. After a while, Canada's dependence on foreign entrepreneurship could become self-perpetuating.

Canadian control is also important for non-economic reasons in certain industries, such as for the development and strengthening of Canadian culture. And, of course, it generally is preferable to have Canadian rather than foreign control—everything else being equal.

For all these reasons, the Canadian government cannot be totally indifferent to country of control. In the main, however, Canadian ownership and control of business is not a sufficient answer to the problems which would remain after general and remedial policies were implemented. A different kind of response is needed to deal with those problems.

THE NEED FOR FLEXIBLE ADMINISTRATIVE INTERVENTION

As Canadian ownership rules will not resolve the problems which would still exist after changes in general and specific remedial policies, a different, but complementary approach is needed to deal with these remaining problems posed by foreign direct investment. The kinds of distortions imposed by the international economy differ from one case to another. The impact which these distortions have on the Canadian economy also differ from situation to situation. As a result, the kind of Canadian response which is appropriate will also vary from case to case and time to time.

In other words, there is the need to have the capacity to respond flexibility in dealing with foreign direct investment. If the problem is ignored entirely, and there is no capacity for the government to intervene, then the Canadian economy will remain exposed to the distortions of the international market place that stem from the intervention of other governments to serve their own national interests, from the nature of the multinational enterprise, and from the existence of international oligopolies in some industries.

On the other hand, a policy which systematically opposes foreign direct investment can close Canada off from new developments in technology and management elsewhere and preclude Canada from access to some foreign markets for certain products. It can also be unduly protective of Canadian management, so that it will be under little pressure to innovate and constantly improve its efficiency.

A flexible approach would allow the government to focus on particular sectors or product lines which show promise of being internationally competitive; the government could concentrate any protection from foreign investment it wished to provide in areas of potential domestic strength, particularly those facing a threat arising from arbitrary international distortions. A more general approach, however, would tend to involve the government in shoring up of the strong and weak alike. A flexible approach would also enable the government response to vary, depending on the nature of the distortion. It would permit the government to protect corporate management for a specific period of time, rather than getting locked into the kind of more or less perpetual or long-term protectionism which typically arises from a statute designed specifically to restrict foreign ownership in a particular industry.

It is perhaps feasible to achieve these objectives through a highly selective use of existing government techniques. For instance, if the government were to decide to review all foreign takeovers of Canadian firms, rejecting those takeovers which were not in accord with the national interests, it might

be able to enforce its decisions by resorting to a prohibitive takeover tax or through some other tax device for such cases as it wished to prohibit. This would amount to a highly selective application of general economic legislation, however, and could conceivably blunt the effectiveness with which that legislation satisfies its other objectives. Therefore, if a policy of flexible administrative intervention is adopted, it would make more sense to pursue it directly through the use of instruments fashioned expressly for that purpose.

The kind of administrative intervention envisaged would provide for the creation of a mechanism through which the government could undertake a continuous review of the plans of foreign direct investors. The immediate objectives of the government in such a process would be: to negotiate with the foreign firm, where this was practicable, to improve the net benefits from proposed foreign direct investment; to block foreign direct investment where this was desirable for economic or non-economic reasons; to seek through negotiations to secure for the economy, where feasible, the distinctive and valuable inputs of the foreigner by other means than direct investment—under licence, for example. This would amount to "untying" the tied investment package and obtaining the foreigner's distinctiveness (say, obtaining his technology on licence or his management ability by contract) without being obliged to accept and pay for other parts of the package which had no particular contribution to make to the economy.

Such a policy is consistent with Canada's present state of economic development. As indicated earlier in this study, Canada now has in aggregate a sufficient volume of savings to finance all or the great bulk of Canada's investment requirements. But Canada is by no means self-sufficient in the other ingredients essential for growth. Canada's capacity to assemble large pools of capital to finance major projects are not sufficiently advanced to meet all domestic demands, nor is the availability of venture capital adequate to meet the needs of industrial entrepreneurs. By the same token, Canada's technological and management capacity has evident weaknesses.

An entirely open policy on foreign direct investment may have been appropriate in earlier stages of Canada's economic development. Current circumstances make it appropriate to consider adoption of a more selective approach—one which takes greater account of the strengths and weaknesses in Canadian capabilities. Administrative intervention allows for such flexibility.

An approach of this kind is also consistent with a policy which recognizes the benefits of international specialization. It is thus not an isolationist policy, but, on the contrary, one which endeavours to integrate Canada into the world economy in a way which will broaden and strengthen Canadian economic capacities and the ability of the nation to meet its objectives for growth, employment and an improved standard of living.

General economic measures, supplemented by more specific remedial measures, could remove some of the problems arising out of foreign direct

investment. Selective administrative intervention would only be required where general and remedial economic policies would not work or were not sufficient. By restricting administrative intervention to the more important cases, the problems associated with administrative intervention should be manageable.

JUSTIFICATION FOR ADMINISTRATIVE INTERVENTION INVOLVING ONLY FOREIGN CONTROLLED FIRMS

There are several reasons for restricting administrative intervention to foreign controlled firms. Some of these reasons also have a degree of validity in respect of Canadian based MNE'S, but the case is most cogent for foreign controlled firms.

The first is that the larger part of the benefits of Canadian controlled investment in Canada is enjoyed by Canadians. If the distribution of the benefits within Canadian society is judged to be unsatisfactory, it can be rectified by domestic economic and social policy. In the case of foreign investment, a larger portion of the benefits normally accrues to interests outside the country and may involve an unnecessarily high cost to the economy owing to the market power of the proprietor. Thus, it is a legitimate aim of public policy to intervene so as to maximize the benefits which remain in Canada.

Secondly, Canadian controlled firms are not as heavily influenced by the foreign environment and foreign governments as are foreign controlled firms. They are more likely to be sensitive to the local setting and the demands of the local economy; they are likely to have a better knowledge of Canadian circumstances, for instance, in the purchase of goods and services in Canada.

Thirdly, foreign controlled firms, and in particular the foreign multinational enterprise, have a greater capacity to frustrate Canadian policy than do Canadian controlled firms.

Fourthly, certain non-economic costs are incurred as a result of foreign direct investment which would not occur in the absence of such investment. Foreign investment, for example, can be the vehicle for the extraterritorial application of foreign law, as well as create the kind of political and cultural problems raised above.

Finally, a government review of the activities of Canadian based multinational enterprises could have adverse consequences which would not result from the screening of foreign controlled manufacturing firms. Government review of foreign controlled firms would normally tend to involve a relatively small part of the parent corporation's global operations. For these firms, Canada is generally a small, though possibly lucrative, market for their output. In contrast, if the government were to review Canadian based multinational enterprises, it would have to examine all their worldwide activities.

In other words, the freedom of action of the Canadian based MNE would be subject to a much greater degree of government intervention than in the case of foreign firms which wish to make an investment in Canada. One difficulty is that this kind of government intervention could drive Canadian based multinational enterprises out of Canada, possibly even in cases where they are heavily dependent on Canadian resources.

THE ROLE OF INDUSTRIAL STRATEGY

It has been pointed out above that there is a need to consider direct administrative intervention in respect of foreign direct investment and some revisions to general economic and other public policies. In themselves, these proposals could have an important influence on the net benefits which Canada derives from foreign direct investment.

At the same time, it is clear that the benefits would be enhanced if these changes could be implemented within the framework of a well-developed and articulated industrial strategy. This is particularly true in relation to administrative intervention, which in the normal course of events would involve the Canadian government or one of its agencies in negotiations with the foreign investor to undertake more production, more exports, more domestic procurement and more R&D of Canada. By indicating areas of specialization where Canadians should concentrate their efforts and resources, an industrial strategy would constitute a safeguard against indiscriminate efforts to develop all industries equally without regard for those in which Canada has the potential to be most efficient.

It has been pointed out that foreign direct investment integrates Canada into a world economy. An industrial development strategy would help to ensure that the integration is on a basis which most benefits Canada's long term interests.

At the same time, it is important to realize that Canada need not wait for the development of a completely defined industrial strategy prior to implementing a foreign investment policy involving administrative intervention. In the absence of such a comprehensive industrial strategy, administrative intervention should seek to achieve an efficient and internationally competitive form of production in each case. It would only bargain for the location in Canada of activity for which there was some underlying economic logic. In effect, administrative intervention should seek to achieve an efficient and internationally competitive form of production in each case. It would only bargain for the location in Canada of activity for which there was some underlying economic logic. In effect, administrative intervention would be employing at least one of the important criteria of a sound and economically justifiable industrial strategy, namely, comparative advantage and economic efficiency.

In formulating an industrial strategy, and in developing a foreign investment policy, it is essential to take account of the relationship between trade

and investment which was described earlier. It must be recognized, for instance, that a foreign manufacturer who is prohibited from locating production in Canada may be able to export here. There is, thus, a need to link very closely government thinking on both trade and investment.

If it were possible to develop an industrial strategy which was fairly precise in terms of identifying sectors of the economy in which the government wished to encourage indigenous entrepreneurship, it would facilitate the use of administrative intervention to foster the development of Canadian controlled companies in emerging new industries which had bright prospects for strong growth in the future. This approach would probably also require the maintenance of tariff protection against imports for a period of time. Because this would involve a double wall of protection against both foreign direct investment and imports, it would be important to adhere strictly to the conditions which justify infant industry protection, namely that the company be in a position to become internationally competitive and bring benefits to the economy that outweigh the initial costs within a reasonable period of time. Alternatively, the government might wish to reduce the amount of protection involved by blocking foreign direct investment in the industry concerned, but maintaining competitive pressures by lowering trade barriers. In such circumstances, all policies—trade, investment and other economic policies—would take their guidance from the industrial strategy. It would not be the foreign investment policy as such which would dictate which sectors of the economy should be protected, unless they were found to deserve protection on non-economic grounds.

Part Six

ALTERNATIVE POLICY APPROACHES

Part Six

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Part Six

INTRODUCTION

The conclusions and implications of the study, which were discussed in Chapter Twenty Four, show the need for a further government policy response to the industrial phenomenon of foreign direct investment. Modifications to general economic policies (particularly fiscal policy, competition policy and commercial policy) could make an important contribution to the development of an economic environment which would stimulate more efficient industrial activity. Furthermore, the introduction of selected "remedial" measures to improve the effectiveness of Canadian capital markets, management, research and development, would serve to enhance the ability of Canadians to assume a greater role in the development of the economy.

The finding and analysis, however, suggest that many problems associated with foreign direct investment cannot be dealt with by adapting the general economic environment in Canada because the problems stem from the international environment and characteristics of foreign controlled industrial activity.

As a consequence, general economic and "remedial" policies alone may not be a sufficient response. Further administrative measures may well be required if the problems remaining are to be dealt with effectively.

It is not being suggested, however, that a response involving administrative intervention ought to be considered any kind of panacea. Unless general economic policies and selected remedial measures are directed towards the creation of a more effective and more efficient Canadian economic environment, more specific measures alone might simply provide a further measure of protection for existing Canadian business operations, both foreign and Canadian controlled. Administrative intervention should not be regarded as a substitute for these more general policy instruments. They are, rather, mutually complementary, each approach helping to reinforce the other.

Specific administrative responses to foreign direct investment may be considered under two broad headings:

(1) FIXED RULES involving such matters as minimum Canadian share ownership, the appointment of Canadian directors and the designation of key sectors;

(2) ADMINISTRATIVE INTERVENTION of a flexible and discretionary nature, applied on a case-by-case basis in keeping with criteria established by legislation, either through a foreign investment review process or within the broader framework of foreign exchange controls.

The relative merits of each of these general approaches, and of the more specific forms of such response, are considered in Part Six.

Chapter Twenty Five

THE REVIEW PROCESS

GENERAL NATURE AND FUNCTIONS OF A REVIEW PROCESS

The analysis undertaken in the study points to four important conclusions:

(i) Foreign investment has a role to play in Canada's future economic development where it is the most efficient technique of obtaining technology, or other needed inputs, and where it contributes to the realization of Canada's industrial objectives.

(ii) Even if improved general economic policies and other remedial measures strengthen the indigenous capabilities of the Canadian economy and increase the benefits from foreign direct investment, a number of "residual" problems would remain, requiring the introduction of special measures to deal with them.

(iii) The costs and benefits of foreign direct investment vary from industry to industry and case to case, with the result that the introduction of general rules lacking the necessary flexibility, would be economically costly.

(iv) Canadian ownership and control of a firm is not a viable proxy for good corporate performance. In short there is a need for a flexible and pragmatic approach to foreign direct investment. This suggests the use of administrative machinery, such as a review mechanism.

A review mechanism could be used as either a "cost-free" or a protectionist device. The term "cost-free" is used here to mean free of costs as measured by national output. This level of output may be expected to grow over time. Economic events and policies will influence the rate of this growth. Use of a new policy, the review process, which is cost-free will not result in any reduction in the growth rate, and therefore will not be the cause of any reduction in per capita income or employment. On the contrary, if it operates as a cost-free instrument, the mechanisms's major function would be to negotiate with such foreign controlled firms as were covered in the scope of its jurisdiction over the quantity and quality of their acivity in

Canada and to do this with a view to increasing the level of efficient economic activity and improving Canada's industrial structure, both of which would contribute to the growth of employment and real incomes in this country. Approached in this way, the review process would be more than just cost-free: it would contribute a net benefit to the economy. In undertaking negotiations, the review mechanism would seek to make the best of the opportunities offered by the multinational form of corporate structure, for example, by encouraging intracorporate rationalization of production and by obtaining the location of more research and product development, exports, procurement or further processing in Canada. It would block foreign direct investment in that relatively small number of cases where such investment would distort Canada's industrial priorities or where it would add nothing of significance to the Canadian economy, as in cases where Canadian capacities already exist and are ready to do the job. A review mechanism would take account of the fact that providing an initial degree of protection for an emerging industry in Canada as a means of fostering its development to maturity is a valid and economically cost-free approach, provided that within a reasonable period of time the infant industry offers the prospect of becoming efficient and internationally competitive, and involving benefits which compensate for the higher costs imposed on the economy during the period of protection.

The ability of a review mechanism to bargain effectively would depend on the existence of adequate Canadian capacities in the entrepreneurial, financial, technological and managerial areas and on the general competitiveness of the Canadian economy, which in turn is ultimately dependent on the effectiveness of general economic policies. Over a period of years—as the cost competitiveness of the Canadian economy develops and alternative indigenous capacities to serve Canadian needs are developed—it is conceivable that a review mechanism could find it possible to block progressively more foreign investment without imposing added cost on the economy.

A review process could also be used to protect Canadian entrepreneurship or other inputs to the industrial process. However, this should be done only where an industrial strategy exists under which areas are identified where Canadian ownership and control could be of significance otherwise this approach should be avoided because it could involve costs that are not justifiable.

There are a number of categories of investment which could be examined by a review mechanism. It could review takeovers, new direct investments originating abroad, new licensing arrangements, new investment projects by existing foreign controlled firms, the activities of foreign controlled firms generally new investments by Canadian multinational enterprises, or some combination of these. The question of the possible scope of a review process is discussed further on, "Establishment of a Review Agency".

Whatever its coverage, a review mechanism would have to be guided by criteria or guidelines established by legislation. These criteria are considered

in greater detail below. In brief, its decisions should be guided by considerations of industrial and economic efficiency, and by the nation's industrial strategy policies.

In addition to its review function, the agency could also:

(i) register foreign takeovers, new foreign investment projects, new licensing arrangements involving foreign partners, and so on, for information purposes;

(ii) advise the government on foreign investment policy;

(iii) perform an advisory or consultative function in relation to foreign investment implications of other government policies and programmes;

(iv) gather information necessary for purposes of identifying foreign control and effective negotiations with foreign investors;

(v) be empowered to conduct investigations on matters relating to foreign investment policy, industries or practices at the request of the minister responsible for its activities.

BASIC REASONS FOR A REVIEW PROCESS

The basic reasons for administrative intervention in dealing with foreign direct investment were given in Chapter Twenty Four above. The reasons which argue specifically for a review process as the means of intervention are set out below:

(i) One aim of policy should be to ensure that a reasonable proportion of the benefits from the investor's distinctive capacities are obtained by Canadians. A review mechanism would allow Canada to marshal Canadian bargaining power in an effort to obtain the maximum benefits possible for Canada from foreign direct investment. Although the review process could not prevent a foreign investor from playing off one province against another for maximum provincial assistance, it could assess the net benefits to Canada of a proposed foreign investment and, among other things, take into account any federal and/or provincial grants that might be involved.

(ii) A review process would be flexible. It could concentrate on that relatively small proportion of foreign investments which are of greatest concern to Canada at any point in time. It could focus on the key variable (e.g., research and development, industrial structure for economies of scale, and so on), which differs from industry to industry and from case to case. It could adapt to different industries and changing conditions over time, in light of the government's industrial strategy, and in light of increased efficiency and new technology which a particular investor might

bring to Canada. As general economic policies and specific remedial measures involving capital markets, technology and management result in strengthening of indigenous capability in particular industries, the need for foreign direct investment could decline. A review mechanism, as opposed to a policy based solely on the designation of key sectors or the introduction of across-the-board ownership rules, would be flexible enough to take account of such changes in its negotiations.

(iii) A review process can and ought to be used as an economically rational instrument. Unlike some of the alternative policies described below, it could avoid the costs to the economy which would result from protecting Canadian owners through blocking all foreign direct investment; blocking all direct investment in a particular industry regardless of its terms or accompanying benefits such as new technology; or establishing fixed percentages or standards for exports, procurement, etc. without regard for the economics of individual industries or cases. The delineation of key sectors to be protected from foreign investment or the introduction of precise formulae covering such things as the extent of exports and the procurement of components would necessarily be arbitrary and thus potentially economically costly.

(iv) A review agency would provide an institutional framework through which the government could take into account the growing importance of foreign direct investment generally and the MNE in particular, assisting Canada to develop industrial and general economic policies which take account of the fact that a growing proportion of industry has a world-wide focus and multinational corporate links.

(v) A review process is a mechanism with which international business is familiar, a fact which would probably make it easier for Canada to use this approach. It would focus on terms and conditions with which businessmen are well acquainted. As pointed out in Chapter Twenty, most countries have some power of control over direct investment. A number of governments have some type of review process.

(vi) The introduction of a review process to examine and improve the benefits of foreign direct investment does raise sensitive issues. These include possible additional uncertainty for some elements of the business community in making some decisions; the additional degree of government intervention a review mechanism represents to the private sector; a new use of federal power in Canada; and the difficulties in making the judgments involved. These problems are discussed later in this chapter.

SCOPE OF THE REVIEW AUTHORITY

In considering the possible scope of the review authority, the following questions are examined:

(i) What specific business functions or activities might be taken into account in reviewing a particular direct investment (e.g., exports, imports, research and development)?

(ii) What criteria should be selected to guide review authorities in arriving at their decisions?

(iii) How would the review process go about dealing with direct investment?

(iv) What would be the relationship between the review process and other government programmes?

(v) What categories of investment—takeovers, new enterprises established from abroad, major investments by existing foreign controlled firms and so on—should come within the purview of the review mechanism.

Each of these questions is considered in turn below.

FACTORS TO BE TAKEN INTO ACCOUNT BY THE REVIEW AGENCY

In order to arrive at a decision on a particular investment, the review authorities would need information on a variety of matters relating to a foreign investor's corporate structure, behaviour, and plans. These factors would be examined in light of the criteria or guidelines discussed in the next section. These are also the areas to which the review authorities would look to improve net benefits to Canada. These factors include:

—the nature of the product line and the nature and extent of rationalization in the corporate organization;

—proposed relationship of the subsidiary to the parent and its international affiliates, including managerial lines of reporting from the subsidiary to the parent;

—the nature of the technology to be employed (in comparison with the technology available in Canada);

—plans for research and development and product innovation in Canada;

—export plans and market opportunities to be made available to the subsidiary, including whether the subsidiary is to be excluded from certain export markets either because of the parent's global marketing strategy or because of the laws, policies or regulations of the parent's home government;

—plans for obtaining equipment, materials, components and services in Canada;

—plans for expansion of the subsidiary;

—plans for the hiring of Canadian managers and other employees, and the appointment of Canadian directors;

—capital structure;
—sources of financing, present and future;
—the opportunity for equity participation by Canadians;
—the degree of processing of resources (if in the resource industries) in Canada.

These factors are not all of equal importance. Their significance for Canadian economic development will vary from industry to industry and from case to case.

GUIDELINES FOR THE REVIEW PROCESS[1]

A review process could concern itself with bargaining for more exports, more procurement and more research and development without regard for their impact on efficient industrial development in Canada. To avoid such a costly approach, the review agency should be directed to follow certain criteria or guidelines in considering industrial foreign investment proposals. Such criteria could be spelled out in legislation or in regulations established under the legislating authority establishing the review mechanism.

These guidelines could include some or all of the points following:

Contribution to Productivity and Industrial Efficiency

A basic guideline applied by a review process should concern the contribution of a particular investment to productivity and efficiency. The application of this criterion would be a substantial guard against inefficient incrementalism, that is, pressing for such things as increased exports or research and development without regard to economic costs.

The use of this guideline would not exclude the protection of Canadian entrepreneurs in circumstances where this protection is short term in nature and would lead in the foreseeable future to the development of an efficient Canadian competitor. The conditions noted earlier for infant industry protection would have to be met.

Compatibility with the Government's Industrial Strategy

A review process should operate within the framework of the government's industrial strategy, to the extent that it is articulated, and could become a potent instrument for its implementation. At the same time, by indicating areas of specialization where Canadians might concentrate their efforts, an industrial strategy would constitute a further safeguard against the review agency promoting indiscriminate development of all industries equally or on an incremental basis.

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[1] The guidelines suggested below apply mainly to the manufacturing and resource industries. It may be necessary to have different, or additional guidelines for some of the service industries, such as rules on disposition of Canadian savings by foreign financial institutions operating in Canada.

Pending a comprehensive industrial strategy, the review authorities would lack one source of guidance in determining what areas of investment should be a matter of special concern to them. In these circumstances, the review authority would seek to achieve an efficient and internationally competitive form of production in each case. It would negotiate the terms of entry in Canada of proposed foreign direct investment which would make a positive contribution to the Canadian economy. This could require, in some circumstances, some form of rationalization within the international corporate structure. The review agency would bargain hardest in industries where Canada has some basic strength. These would probably be industries where a good case can be made for concentrating activity under an industrial strategy. In effect, a review process would be employing at least one of the important criteria of any sound and economically justifiable strategy—comparative advantage and economic efficiency.

Contribution to the Level of Economic Activity and Employment

Increased economic activity and employment can be among the major benefits of foreign direct investment. A review agency should therefore also take into account the impact of a particular investment on these factors. In weighing these factors, it is equally important that the agency not operate on a basis of economically unsound incrementalism, but in accordance with the government's industrial strategy and the efficiency guidelines mentioned above.

Geographic Location within Canada

A review process could also be used to support the government's desire to improve economic conditions in the slow growth regions of the country. The review agency could be directed to regard location in a slow growth region as a positive benefit in assessing the net impact of the investment on Canada. However, if the foreign investor locates in a designated region because of a DREE grant or other government incentive, the review agency should, as a general rule, apply the same criteria as it would to foreign direct investment in other areas of the country. If it did not, the investor would in effect be benefitting twice.

Competitive Impact of Foreign Direct Investment

Foreign direct investment, whether it is in the form of a takeover of an existing company in Canada, or the establishment of a new enterprise, can have a significant impact on the degree of competition in an industry. To the extent that the impact on competition would be positive, the review agency should regard it as a benefit to be derived from the investment in question.

In the case of takeovers, a role for a review agency need not conflict with the responsibilities of the proposed Competitive Practices Tribunal (CPT), which would have statutory authority to determine the competitive impact of takeovers. Each agency would apply its set of criteria to the takeover. The potential relationship between these two agencies is considered below. In brief, a takeover which contravenes the proposed Competition Act would be blocked by the CPT and would not come before the review agency. A takeover that was neutral in its effect on competition would be examined by the review agency, but it would not consider competitive stimulation as one of the benefits flowing from it; a takeover judged by the CPT to stimulate competition would be considered by the review agency, which would take into account the beneficial impact on competition in arriving at its overall cost/benefit judgment.

Other Economic Benefits

A review process should also consider the actual and potential spillover benefits from foreign direct investment, such as the training of Canadian managers and labour.

The various aspects of corporate behaviour would be considered in terms of their impact on these guidelines.

It is conceivable that in examining a particular case, there may be some conflict between these guidelines, that is, between efficiency and greater activity. Any conflict of this nature would have to be resolved by a decision based on the government's overall priorities, which are likely to change from time to time in response to the changing domestic and international situation.

APPROACH TO DIRECT FOREIGN INVESTMENT UNDER THE GUIDELINES

The application of these guidelines would lead to the treatment of foreign direct investment in one of five different ways:

(i) In most cases of proposed foreign direct investment registered with a review agency, there would be no negotiations or refusal of entry because the value of the investment would be below a threshold of economic significance. Such a threshold would likely have to be established for reasons of administrative feasibility. (The matter of thresholds is discussed further in sections below.)

(ii) In some cases of economic significance, foreign direct investment would be welcomed because it offers some element of distinctiveness superior to that of Canadian firms and which cannot be acquired more efficiently via licence or through a joint venture. In these cases, the review authorities might negotiate with the investor over terms of entry if they believed that more of the investor's total operation could be based economically in Canada. In most cases this would involve rationalizing production within

the MNE. The rationalized structure would allow the Canadian subsidiary to realize significant economies of scale and to play a more important role in the international corporate structure. Because the foreign investor's distinctive capacity is often great and his bargaining position strong in these cases, negotiations may not result in substantial added benefits.

(iii) In other cases, the distinctiveness may not be as great or Canadian controlled firms may exist that can develop it. In these cases, the review authorities could seek to have the distinctive capacity acquired in Canada under licence, or they could promote the establishment of a joint venture with a Canadian firm. If this proves unsuccessful, or if it is decided to allow the foreign investment for other reasons (perhaps because of its contribution to technological efficiency, employment, competition or regional development), bargaining may nevertheless take place in order to try to maximize net benefits to Canada.

(iv) In other cases, perhaps involving industries made up of both Canadian and foreign controlled firms, the review authorities may determine that new foreign direct investment would not add anything new, say in the way of new technology, markets or competitive stimulus. The investment may even be detrimental, distorting industrial priorities or have anti-competitive effects, for example. If nothing of value is being brought to Canada, the entry could be refused. This would not be motivated primarily by the desire to protect Canadian entrepreneurs, but rather to maximize net economic benefits to Canada. Blocking is least likely to occur in the case of new investment in manufacturing, where a Canadian alternative may not be available. It is more likely to occur in the case of takeovers, particularly in the resource industries where the foreign acquirer may contribute very little.

In summary, foreign investment would be resisted in cases where:

—the Canadian economy is strong so that foreign investment is not vital to economic development;

—foreign investment distorts Canadian industrial priorities (perhaps because of foreign government incentives which cannot be effectively "neutralized" or captured);

—foreign investment has anti-competitive effects.

It should be emphasized again that the ability to resist foreign direct investment depends to a large extent upon the existence of Canadian capacities. This serves to underline the importance of having aspects of a positive nature in a foreign investment policy. Successful measures of a positive nature should, over time, reduce the need for foreign investment. A foreign entrant who today possesses a superior distinctiveness might tomorrow be resisted or be required to enter Canada via licence or joint venture. Im-

proved Canadian capabilities should also increase the bargaining power of a review agency and permit it to negotiate better arrangements. Similarly policies designed to improve the general economic environment—making all industry more efficient regardless of ownership—would affect the extent to which the review authorities have to bargain over certain elements. For example, the market itself might produce less fragmentation if more competitive conditions and access to larger markets exist and lower production costs make it easier to attract foreign firms to undertake various activities in Canada.

(v) There is a category of industry which the government may decide to reserve for Canadian controlled firms for economic or mixed economic and non-economic reasons. These include the culture-based industries and industries where the government believes that Canadian controlled firms are desirable because of the vital part such industries play in the operation of the economy as a whole. There is a further discussion of these industries in Chapter Twenty six dealing with key sectors. The government might also wish to protect a particular industry for Canadian controlled firms if it is believed that it could develop into an efficient international competitor within a reasonable period of time.

Negotiations by a review agency would represent an attempt to reduce truncation or to obtain the distinctive capacity at a lower cost—for example, by reducing or removing export restrictions, by requiring greater production, procurement or R&D in Canada where economic. In many cases, this would also give Canadian entrepreneurs and suppliers greater opportunities to increase production, employment, and efficiency.

Bargaining could take place on some or all of the following factors:

—degree and nature of rationalization including production for export markets, or the shifting to Canada of production of components for parents and affiliates abroad;

—the location of research and product development facilities in Canada;

—possible future expansion in Canada;

—degree of processing of raw materials in Canada.

While less practicable in most situations, bargaining could, in some cases, take place over the nature of the product line or the nature of the technology to be used. An attempt could be made, for example, to obtain the use of more modern technology in Canada. Depending on the balance of payments situation and the domestic credit situation, bargaining may also take place over sources of financing. The review authorities may wish to urge the foreign investor to import all his capital requirements, or alternatively, to raise needed capital from Canadian sources. The use of Canadian man-

agers and directors,[2] opportunities for Canadians to obtain equity, and long-term balance of payments effects (if known)[3] might normally not be matters for bargaining, but could be taken into account in the final cost/benefit judgment. Transfer pricing, as a tax revenue problem, can be best handled through tax law and its administration.

In arriving at its final cost/benefit judgment, the review authorities would consider whether equal or greater benefits were available from a Canadian source. They might also consider the possibility of trying to separate the total foreign direct investment package in order to obtain the distinctive capacity in a form other than through direct investment—perhaps through a joint venture of the foreign enterprise with a Canadian firm, or obtaining the technology under licence. A review agency could also, in some cases, look at the possibility of obtaining the distinctive input from an alternative foreign source.

The guidelines suggested above envisage the review process as a mechanism which would impose no costs on the Canadian economy, but on the contrary offer a potential for increased economic efficiency and employment opportunities. If the government is prepared to countenance some economic costs for the purpose of producing long-run benefits, it could consider proposing that the review agency be authorized by statute to provide an element of protection under certain circumstances and for a limited period for particular industries. It could, for example, protect an industry where Canadian entrepreneurs are judged to be at the "take-off" point, by blocking a proposed foreign takeover or new foreign investment. Alternatively, where the government found that Canadian ownership is important to the realization of certain objectives, it could identify key sectors to be protected for development by Canadian controlled firms.

With the development of government policy as to industries whose development would be encouraged, it would be possible to add this element of protection of Canadian entrepreneurs without great difficulty. Until this policy is articulated, the review process should probably be a non-protectionist mechanism. If desired, protection of Canadian entrepreneurs can be built in at a later state as the government's industrial strategy is more fully defined and/or when judgments about particular sectors become more fully developed as a result of the operation of a review process.

RELATIONSHIP OF THE REVIEW PROCESS TO OTHER GOVERNMENT PROGRAMMES

The use by a review process of the criteria suggested above will have implications for other government programmes and policies, such as trade, industrial, mineral, employment and regional development policies. This raises the question of the relationship of a review process to these programmes and to the departments that are principally responsible for their implementation.

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[2] See Chapter Twenty Seven.
[3] See Chapter Fourteen.

A review process could operate within the framework established by these policies and the departments responsible for them. It could cooperate with departments in the implementation of these programmes and policies insofar as they raise issues related to foreign investment policy. Indeed, to the extent that the government has defined its general economic and industrial strategy, all programmes and policies—including a review process—would be working to achieve the objectives involved.

A review agency could have an advisory role in relation to other department's policies which affect foreign investment in the economy.

There is a danger that a review process would become an instrument for the implementation of a variety of government policies and programmes unrelated to the objectives of the review process. For instance, pressures could develop to block a particular foreign investment unless certain anti-pollution steps were taken. This risk would be minimized if a review process is guided strictly by its own criteria in making decisions with other considerations being dealt with by other arms of the government.

Arrangements for consultation and cooperation with other departments and agencies in the operation of the review process will further help to avoid any conflict or overlap between a review process and other departments. The discussion below on administrative procedures elaborates the type of administrative relationship with other departments that is envisaged.

WHAT CATEGORIES OF INVESTMENT COULD BE REVIEWED?

Legislation could require registration with the review agency of the following:

(i) takeovers of Canadian firms, whether Canadian or foreign controlled, by foreign interests and whether the acquiring firm was or was not already established in Canada;
(ii) new enterprises established from an external base (i.e., foreign companies making direct investment in Canada for the first time);
(iii) new licensing and franchising arrangements;
(iv) major new investments by existing foreign controlled companies in Canada;
(v) existing foreign controlled companies, even if they are not planning major new investments;
(vi) major new investments abroad by Canadian based multinational companies.

The review agency could be authorized to review and bargain over one or more of these categories of investment. The pros and cons of these alternatives are considered below.

Before proceeding, it should be recognized that the degree of intervention involved in screening will vary not only with the kinds of transactions which fall within the jurisdiction of the review mechanism, but also with the number of cases covered in each category. It is unlikely that all investments in each

category would be subject to review. The review authorities would normally concentrate on transactions of economic significance. By limiting the review process to major transactions, it would be possible to maximize economic impact while minimizing the number of cases subject to intervention. This question is considered in greater detail below.

Foreign Takeovers

General

A review authority could look at foreign takeovers of Canadian firms, whether Canadian or foreign controlled and whether the foreign acquiring firm was or was not already established in Canada. In performing their function, the review authorities could apply the general guidelines relating to all foreign investment set out above. Briefly, an assessment would be made of the advantages of the proposed takeover in terms of its contribution to efficiency, employment, competition and so on. If superior terms were possible, the agency would negotiate for them. If little or no contribution would be made to the industry by the foreign participant, it would be blocked.

This approach could sometimes place the individual Canadian seller in a less favourable position, as the group of potential purchasers would be somewhat narrowed. This of course could also happen under the *Combines Investigation Act*, the *Bank Act*, the *Broadcasting Act*, and other legislation designed to effect a balance between private interests and public benefits. Only a small number of individual proprietors would be affected because of the operation of the size criterion and because acquisitions of small firms are much less likely to be blocked.

A proposed takeover, whether it involves a foreign takeover of a Canadian controlled firm, or of a foreign controlled firm which is changing hands, provides an opportunity for a review agency to determine if a Canadian buyer is available. The objective would be to find a Canadian proprietor who could do a better job, or at least as good a job, and maintain for Canada the advantages of Canadian ownership identified in Chapter Twenty Four. While a review authority might canvass the possibility of securing a Canadian buyer, in the event no Canadian buyer emerged it could authorize the foreign takeover if it appeared to offer sufficient advantages to the economy. Consideration could be given to providing for a prescribed waiting period between a proposed foreign takeover and its completion, during which public notice of the intended purchase would be given to permit any potential Canadian buyer to come forward. However, the foreign takeover policy cannot hinge on a requirement of finding an alternative Canadian buyer on comparable terms, since to do so would seriously undermine any takeover policy; nor should the government adopt the posture of being a buyer of last resort. It should simply use its statutory authority to prohibit undesirable foreign acquisitions.

A time period should be provided for a review agency to declare its position—say sixty days from the date on which all required information has

been submitted. If no government objection were made, the takeover might proceed automatically. If the agency indicated it was prepared to challenge the takeover or to bargain over its terms, however, the issue would then come under consideration. It is open to question whether the bargaining process should be subject to any statutory time limit, since it might undermine the bargaining position of the agency.

Relationship of the Screening Agency to the Proposed Competitive Practices Tribunal

Under the terms of the proposed Competition Act, an acquisition of a Canadian firm by a foreign interest would have to meet the general merger provisions and the rules applying to foreign takeovers as administered by the *Competitive Practices Tribunal*.[4] These would remove from the review process takeovers that are harmful to domestic competition and which have no redeeming virtue in creating new efficiencies. However, the rules under the proposed competition policy would only block those takeovers which had an adverse impact on competition. The *Competitive Practices Tribunal* could not prohibit takeovers which neither helped to stimulate competition nor brought other benefits to the economy. Such questions could be considered by a review process concerned with foreign investment.

In blocking proposed takeovers which add nothing of value to Canada, or in bargaining for greater benefits, the review authorities could examine proposals involving large Canadian firms more closely than those involving small ones. A takeover of a smaller firm is more likely to benefit the economy than the takeover of a large firm in the same industry, which frequently involves a simple change of owners with little or no improvement through the introduction of new technology, economies of scale or other benefits.

If a review process were implemented, a proposed takeover would be subject to examination by two public bodies. This cannot be avoided, however, without removing all consideration of foreign mergers from competition policy, or all takeovers from the jurisdiction of the review process. Neither of these alternatives is desirable for both policies would be serving a well defined public objective. It would be inappropriate to have the review authorities administer competition policy for foreign takeovers and the *Competitive*

[4] The general merger provisions in the proposed legislation empower the Tribunal to examine mergers which "significantly lessen competition". Such a merger would be prohibited unless it resulted in efficiencies, a substantial part of which were likely to be transmitted to the market place. A foreign takeover would be subject to these general rules.

Since a foreign takeover might not *lessen* competition from a previous level, but still be detrimental to competition, a further set of rules would be applied by the tribunal. The grounds for having these additional rules are basically that a foreign takeover can create or entrench market dominance on the part of the acquired firm in Canada; that the influence of a foreign cartel or oligopoly may be introduced into Canada as a result of the takeover, reducing the competitive independence of the acquired firm; or that the takeover could lead to a restriction of production or exports by the Canadian firm. In each case, the defence applicable to Canadian mergers would be possible, namely that the acquisition would lead to a significant improvement in efficiency, with a substantial part of the benefits being transmitted to the market-place.

Practices Tribunal for domestic mergers, since conflicting interpretations of competition policy could arise. Furthermore, the review process envisaged in this analysis would not be an independent adjudicative agency, unlike the proposed *Competitive Practices Tribunal*. The other alternative—foregoing the examination of takeovers through a review process—would preclude blocking those foreign takeovers which add nothing of benefit to Canada and also remove the opportunity to bargain for increased benefits from those allowed to take place. A procedure whereby takeovers are considered by the proposed *Competitive Practices Tribunal*, prior to review by a screening agency, would reduce to a certain extent the number of takeovers left to the more discretionary review process.

To mitigate the problem of a businessman having to deal simultaneously with two government agencies over the same takeover, the foreign purchaser could apply to the review agency for approval, and it, in turn, could be required by law to notify the *Competitive Practices Tribunal* and the Commissioner under the proposed Competition Act. The review agency would conduct its preliminary investigations while the Tribunal deliberated over the takeover. If the Tribunal did not oppose the takeover, the review agency would be able to enter into discussions with the foreign investor immediately, thus reducing any delays. The foreign investor would make only the one application to the review process, thus providing him with one point of initial contact with the Canadian government. Only a few foreign takeovers can be expected to involve two full steps of examination. They would usually be the ones which are of doubtful benefit to Canada.

New Enterprises Established From an External Base

The following arguments can be made for going beyond takeovers in the review process:

(a) New foreign direct investment can have the same adverse economic impact as takeovers—by restricting competition, for example.

(b) The scope for bargaining to obtain greater benefits for Canada is probably greater in the case of new investment than in the case of takeovers.

(c) Without the ability to screen new enterprises established from an external base, the takeover rule could become less effective. For example, if the review agency blocked the takeover of a Canadian firm because the foreigner would not add anything of significance to its operations in terms of technology, managerial efficiency, markets, etc., there would be nothing to stop this particular foreign direct investor from setting up a company in Canada and perhaps managing to drive the Canadian out of business. He would be eliminating, through the avenue of new investment, a company which the review process thought should be protected and remain in Canadian hands. If this occurs as a result of superior efficiency, there is a net economic gain for Canada. But if, on the other hand,

it occurs as a result of sheer market power, there could be a net economic loss, as well as a diminution of Canadian ownership. This dilemma could be avoided if competition and other general economic policies created an environment which would effectively preclude predatory action.

There is a further consideration. The prospective Canadian seller, anticipating that the proposed foreign buyer might enter the Canadian market directly as a competitor in the event the takeover of his firm did not go through, might urge the government not to bargain too vigorously over the transaction. He would claim that there would be no net economic benefits to Canada if the acquiring firm should later enter through new investment rather than takeover. He might also argue that the selling price of his business would be adversely affected either if the terms of the takeover demanded from the prospective foreign buyer were onerous, or if the foreign firm entered the Canadian market directly in the event the takeover was blocked.

(d) The review of proposed new foreign investment in the natural resource industries would provide the government with a particularly valuable instrument to deal with the problem of maintaining balanced economic development and employment for Canada's growing labour force in the face of the mounting foreign demand for Canadian raw material.

(e) The ongoing development of an industrial strategy might also be assisted by the information and experience gained in dealing with particular new investments through a review agency. Reviewing new investment could be an additional tool in the government's arsenal to deal with balance of payments and exchange rate problems, with foreign investors under certain circumstances being required to raise funds either in Canada or abroad, depending on the balance of payments situation.

The approach to new foreign investment would be basically the same as that set out above for foreign takeovers. The review agency would have to be notified of all new enterprises established from an external base. Since the focus of concern would be investments over a certain size, most new investments would be likely to proceed without further action by the agency.

The agency would have to negotiate for the best terms possible for Canada from a proposed investment, assuming it had potential benefits to offer. Similarly, it would be open to the agency to block the entry if its evaluation led to the conclusion that the net benefits to Canada were not significant or were negative.

While the same general criteria would apply to takeovers and new investment (impact on productivity, industrial efficiency and the industrial structure, contribution to the level of economic activity and employment, geographic location, competitive impact, and so on), there is much less likelihood

that new investment would be blocked. Indeed, because of the potential new activity and competitive stimulus of new investment, the bias would probably be in favour of allowing new investment. Takeovers would likely be looked at more critically.

In the case of new investment, the review agency could also give consideration to the alternatives of a joint venture with a Canadian producer or the licensing of an independent Canadian entrepreneur if a viable Canadian partner exists.

The value of licensing arrangements involving use of foreign technology or know-how and joint ventures lies in the fact that they may impose fewer restrictions on the activities undertaken in Canada and result in greater benefits to Canada. More generally, these techniques permit greater Canadian influence over the industrial activity involved while, at the same time, they give Canada the benefit of the superior foreign inputs. The licensee is generally left some latitude in management, production, procurement, sales and pricing. He is freer and more likely to "shop around" for various inputs, including the pursuit of alternative sources of the technology if other preferable sources exist or arise at a later date. This is not to suggest that the multinational enterprise does not search out new or lower cost technologies, which are ultimately made available to the Canadian subsidiary, but that the Canadian operation may be tied more closely to the single source of technology—to the possible disadvantage of Canada.

To achieve maximum benefits from a licensing arrangement, the Canadian partner must have the capacity to select wisely, and to operate and develop the "know-how" which is made available at arm's length. It is also important that he be able to profit by it if he develops or improves the "know-how".

Licensing arrangements may not lead to a continuing relationship between the companies entering into them, whereas foreign direct investment ordinarily provides easy access to the latest developments within the enterprise. In the case of licensing arrangements, further development of the "know-how" which has been transferred may have to be further negotiated by the licensee. On the other hand, it must be remembered that direct investment can lead to the establishment of rigid patterns of dependence on one source for needed technological or other inputs. This may lead to the use of a technology inappropriate to the Canadian scene or delays in obtaining the best and cheapest technology available elsewhere.

The foreign proprietor of the "know-how" will often favour direct investment as a technique of maximizing his benefits. But he may have a variety of reasons for not doing so. If he lacks resources and can gain most of the benefits through licensing, he might favour this technique. He might also be wishing to take advantage of a Canadian's existing distribution channels.

The possibilities for the review authority to encourage the use of licensing and the bargaining capacity of the potential Canadian licensee will vary from case to case, depending upon the viability of this form of transfer, the

possibilities of indigenous development taking place, and the terms attainable through licensing.

A joint venture is a half-way house between direct investment and arm's length procurement of the distinctive input. The presence of a Canadian participant in the management of an enterprise can increase the benefits for Canada. The appropriateness of this technique, and the extent to which it adds to the benefits for Canada, will also vary from one setting to another.

Finding a Canadian partner with the requisite capacities to enter a joint venture may be difficult. The inputs which each partner has to make are particularly important if the joint venture is to thrive. If the partners are very unequal, the prospects are less bright. Similarly, the more dynamic the setting, the more precarious is the joint venture. This is the case because the distribution of responsibility and proceeds may become inappropriate in a rapidly changing situation, putting heavy strains on the partnership. The likelihood of indigenous development by the joint venture and the degree of independence which it might achieve from the foreign participant might also affect the attitude of the review agency toward proposed enterprises in this form.

A review process could also remain alert to the possibiilty of encouraging the use of contracts for the transfer of particular capabilities or skills—management contracts, for example.

While there is potential for greater benefits from licensing arrangements and joint ventures, these techniques can also be accompanied by conditions and restraints which are as confining as foreign direct investment. Furthermore, these business relationships are not appropriate for the transfer of all distinctive inputs, so that a general policy insisting on their use in all cases would be inappropriate.

Licensing Arrangements, Joint Ventures and other Contractual Arrangements

Although it may be in Canada's interest to encourage the use of licensing, joint ventures, management contracts or similar arrangements in some instances, careful attention must be given to the terms involved. Indeed, a case can be made for reviewing all arm's length arrangements of this nature including those which were encouraged by the review process itself.

Firstly, the kinds of restraints which would concern the review authorities in examining foreign direct investment, such as export restrictions, tied procurement and exorbitant fees, can be imposed on Canadian business through techniques such as licensing agreements, joint ventures and controlling contractual arrangements.

Secondly, these contractual techniques can be used, in some cases, to exercise effective control of a company and could thus lead to circumvention of the government's objectives with respect to direct investment.

Thirdly, it is worth considering attempting to enhance the bargaining position of the Canadian buyer, or otherwise improving the terms of the contract for Canada, much as in the case of new investment. The foreign partner or licensor is in the position of a single seller facing a number of alternative Canadian buyers. Each prospective Canadian buyer can perhaps offer access to a portion of the market. The review agency might be able to reduce the ability of the seller to play off one potential Canadian buyer against another, by exacting some basic conditions for the arrangement.

It must be recognized that a decision to review business arrangements of this nature would affect the activities of Canadian controlled firms, much as would a foreign takeover rule. It is not possible to determine precisely how many instances would be involved, as there are very little data available. Some rough estimates are made below. Efforts should be made to obtain better information on the frequency and economic impact of licensing arrangements in Canada.

Major New Investment of Existing Foreign Controlled Firms

The question of reviewing major new investments by existing foreign controlled firms must also be considered. These investments could be either in the form of major new additions to capacity in the same industry, or investments in an entirely new line of business. They may or may not involve the use of Canadian capital markets (including new issues of stocks or bonds).

Some of the arguments for reviewing major investments by existing foreign controlled firms include the following:

(a) In strict economic terms, a new investment by a foreign controlled firm already operating in Canada, whether it is a major expansion of an existing business or entry into an entirely new line of business, is fundamentally no different from an investment by a new entrant to Canada.

(b) The foreign controlled sector of Canadian industry is very large and an increasing proportion of its continuing growth is being financed from internal resources. Indeed, existing foreign controlled firms are the most important source of the growth of foreign control in Canada.

(c) Failure to review major new investments by existing foreign controlled firms would give them a degree of advantage over potential new foreign entrants, a fact which may be undesirable for industrial development and competitive reasons.

(d) The bargaining strength of the review agency might be reduced if applicants could point to existing competitors who are not

subject to constraints on behaviour by virtue of having entered prior to the policy coming into force.

There are, however, arguments against screening major new investments by existing foreign controlled firms.

(i) A policy which seeks to review investments by these firms, especially if it seeks to consider additions to capacity, would be regarded by some critics as having retroactive impact particularly because it would interfere with the firm's use of retained earnings.

(ii) It could adversely affect the competitive environment by placing the foreign controlled firms under a review process not imposed on their Canadian competitors.

(iii) It would represent a fundamental change in the rules of the game by the government. In particular, it would be more interventionist, and would alter the traditional relationship between business and government.

(iv) There would be misgivings in some quarters about the fairly widespread substitution of administrative judgment for the working of the market place. There would be concern about the government's ability to make decisions on economic criteria alone without allowing other considerations to intervene and about possible errors in judgment by the review agency.

(v) The displacement of the market place and the substitution of administrative judgments could lead to a temporary drop in investment by existing foreign controlled firms and perhaps, over the longer run, make Canada a less attractive location for investment. Furthermore, a stultification of innovative activity in the economy could also result.

(vi) Such a policy could conceivably create problems in relations with foreign governments if existing foreign controlled firms sought to enlist the support of their home governments, arguing that their normal growth in the Canadian market would be affected.

These problems could possibly be reduced over time as the operation of the review agency demonstrated to foreign investors and the Canadian business community that the main objective is not to block foreign direct investment which can make a significant contribution to efficient Canadian development.

There follows an examination in more detail of possible alternative methods of screening the existing foreign controlled sector. The discussion considers the question of major investments by existing foreign controlled firms in new lines of business and major investments in their current line of business. It also considers the question of major capital drawings either from abroad or through domestic capital markets by such foreign controlled companies.

Major Investment by an Existing Foreign Controlled Firm into a New Line of Business

A major investment by an existing foreign controlled firm into a new line of business has almost all the characteristics of a new investment by a foreign controlled company not yet established in Canada. Many of the same arguments in favour of reviewing new investment from an external base also apply to this category of investment.

Reviewing major investments by existing foreign controlled firms into new lines of business would represent an added degree of interventionism, but there are no data to indicate how significant this would be. It seems unlikely that there would be many investments in this category, for most corporate investment tends to be in specific sectors, that is a corporation usually invests in the industry in which it is already operating and which it knows best.

Some of the arguments mentioned above against reviewing the existing foreign controlled sector would apply as well in this more limited category since it would affect the operations of at least some existing foreign controlled firms. These arguments would not, however, be as significant since in this case an existing foreign controlled firm would, in effect, be proposing to change its line of business. But such a move would raise the difficult definitional problem of what constitutes "a new line of business."

Major New Investments in Current Lines of Business

Reviewing major new investments in current activities (e.g., large additions to capacity) would impinge more substantially on the operations of existing foreign controlled firms. It would be criticized on the ground that such a review interfaced with a firm's use of its retained earnings and its ability to grow. All the arguments against reviewing the activities of existing foreign controlled firms set out above would apply here in even greater measure. In substance, it raises the broader question of whether the activities of existing foreign controlled firms should be subject to review under the guidelines of the review authority.

Major Drawings on Canadian Capital Markets or Capital Imports

The concept of reviewing major drawings on Canadian capital markets is one alternative approach which would permit a review process to examine most major expansions and, where appropriate, to negotiate about various aspects of the proposal. By putting the government in the position of reviewing the use of Canadian capital markets for certain purposes, it could provide one means of dealing with the contention that foreigners are simply employing Canadian financing resources to increase their control of domestic

industry. It would also give the government an additional instrument to deal with balance of payments and exchange rate problems. It could help ensure that foreign controlled firms tapping Canadian capital markets were not displacing potential Canadian users of those funds. Lastly, it avoids any attempt to review the use of retained earnings and other internal resources by foreign controlled firms. This approach would also require the review of large capital imports by foreign controlled firms, since a capital import can also displace Canadians from Canadian capital markets if the government were forced to borrow to finance the foreign exchange transaction resulting from the capital inflow.

While permitting the review agency to deal with most major expansion, this technique would tend to give a preference to a firm having internal resources within Canada, which could as a result not have its expansions subject to the review process. It would also lead to attempts to transfer funds to the subsidiary from affiliates abroad in non-equity forms (e.g., through transfer pricing techniques in order to avoid the review mechanism).

Existing Foreign Controlled Firms Not Making Major New Investments

The broader question of reviewing the nature of the operations of existing foreign controlled firms, regardless of planned expansion or use of Canadian capital markets, raises difficult questions.

As pointed out above, the foreign controlled sector in Canada is large and much of its continuing growth is being financed from internal sources. There are arguments for reviewing this as well. In some respects, it could be argued that the economic case for reviewing foreign direct investment is strongest in the case of these firms. As they have an established market, a market image which they have worked to develop and a committed investment, Canadian bargaining power is probably stronger with these firms than in relation to new foreign investors. The potential benefits are great, if for no other reason than the large number of firms involved. Furthermore, to avoid reviewing existing foreign controlled firms would favour these over new entrants—providing them with some degree of protection, over new foreign competition, or at least of preference. In some sectors, most of the potential foreign investors are already here and there is little likelihood that new foreign investment or takeovers will occur.

Among the arguments against reviewing existing foreign controlled firms that are not undertaking major investments are the following. Reviewing existing foreign controlled firms (or even the major ones) on a regular basis would represent a substantial degree of governmental intervention in the economy, probably requiring a large organization to follow the activities of particular firms. Covering such a large number of firms would create serious administrative difficulties.

The guidelines to good corporate citizenship on the part of foreign controlled firms in Canada, issued by the government in 1967, provided one

response to the problem of existing foreign controlled firms and the concern that was felt about them at that time. On the whole, they do not appear to have had a significant influence on the way in which foreign controlled firms in Canada conduct their affairs. However, there is merit in retaining these guidelines because the objectives they sought to achieve remain equally valid and desirable today. Much of this study, in fact, is directed to exploring ways and means of achieving many of these objectives more fully in future than has been the case in the past.

Thus in dealing with existing foreign controlled firms, there are the following policy alternatives: (i) reviewing existing foreign controlled firms whether they are undertaking major investment programmes or not; (ii) reviewing only foreign controlled firms that are undertaking major new investments either in their own industry or in a new industry; (iii) reviewing foreign controlled firms that are making significant use of Canadian or imported capital for major new investments either in their own industry or in a new industry; (iv) reviewing only foreign controlled firms that are making major new additions to capacity in their own industry; (v) reviewing foreign controlled firms that are making new additions to capacity in their own industry and using Canadian capital markets or imported capital; (vi) reviewing only foreign controlled firms that are entering a new line of business; (vii) reviewing only foreign controlled firms that are entering a new line of business and making use of Canadian capital markets or imported capital.

In the absence of a review of existing foreign controlled firms, the question of alternative techniques arises. These could involve adding to the present programs and policies of selected key sectors, *Industry, Trade and Commerce* guidelines, tax provisions, the use of moral suasion, and for such objectives as industrial rationalization, grant or loan programme designed to offset some of the initial costs of a foreign controlled firm that rationalized its activities with its parent. Grant or loan programmes could achieve some objects of a review process, by being made conditional or certain commitments. This is a use of incentives rather than of an exercise of public authority, with the incentives being financed by Canadian taxpayers. In any event, arguments can be made for paying attention to the activities of foreign controlled firms benefitting from substantial governmental support in the form of grants, loans, or large procurement contracts, with a view to obtaining better performance from them. Those responsible for reviewing foreign investment could be given a consultative role in this area. As a minimum, government consideration could be given to setting up a comprehensive program for recording the extent to which foreign controlled firms benefit from public assistance.

Canadian Controlled Multinational Firms

While the analysis in this study has focused on foreign controlled firms, it was noted that Canadian firms can also truncate their Canadian operations

in much the same way as foreign controlled corporations. Canadian firms which mature to a multinational stature show symptoms of being influenced by their larger markets abroad. This suggests that consideration might usefully be given to applying many of the approaches suggested in the case of foreign controlled firms to Canadian multinational firms, despite their Canadian ownership. There are arguments against this. Reviewing Canadian MNE's would involve scrutinizing the entire operations of these firms including the activities of all their foreign subsidiaries. Reviewing foreign controlled firms would, by contrast, involve looking primarily at only one branch of the foreign MNE's operations, thus subjecting Canadian MNE's to a wider review than a foreign owned firm. Therefore, subjected to this greater degree of review, it is likely that a high proportion of Canadian multinational enterprises would locate their headquarters elsewhere, with Canada losing those benefits associated with having the headquarters in this country.

CRITERION OF ECONOMIC SIGNIFICANCE

It is suggested that only transactions of economic significance—or of particular importance due to the nature of the activity involved—should be subjected to the detailed scrutiny by a review agency. This would limit considerably the extent of foreign direct investment that would come within the review process.

Consideration would have to be given to having thresholds of economic size and significance which would vary by sector, since firms of some industries are small, but potentially quite significant. Consideration would also have to be given to varying the threshold between takeover, new investment by new entrants from abroad, and existing foreign controlled firms, even though different thresholds for these categories of investment could not be based solely on economic considerations. One way of achieving some flexibility would be having the size criterion determined by regulations, rather than being embodied in the legislation. Some indication of the magnitude of investment in recent years related to takeovers, capital expenditures by new foreign entrants into Canada and by existing foreign controlled firms follows below.

TAKEOVERS

Table 57 covers takeovers of Canadian enterprises by asset size for the years 1968 and 1969. It shows that there were five takeovers in 1968 and seventeen takeovers in 1969 of enterprises having $5 million or more in assets. The year 1969 appears, however, to have been somewhat atypical in the number of large takeovers that occurred. On the other hand, 1968 was probably not typical also, in that there were no especially large takeovers that

year. In respect of the remainder of the size distribution, there is no reason to believe that 1968 or 1969 were especially unusual.

At a threshold of $250,000, there were 88 takeovers in 1968 and at least 85 in 1969.

TABLE 57

FOREIGN TAKEOVERS OF CANADIAN ENTERPRISES BY TOTAL ASSET SIZE GROUP FOR 1968 AND 1969*

($ Millions)

	1968		1969	
Total Asset Size Group $	No. Total	$ Assets	No. Total	$ Assets
Over 35 million	—	—	3	397
18 million	—	—	6	462
5 million	5	50	17	556
4 million	10	72	21	574
3 million	18	100	29	599
2 million	23	113	38	620
1 million	46	146	59	649
500 thousand	74	166	85	668
250 thousand	88	171	—	—
100 thousand	102	172	—	—
1 thousand	103	173	129	678
Total	103†	173	129	678

*SOURCE: Statistics Canada.

†It was not possible to allocate 14 takeovers by asset size.

NEW INVESTMENT

According to Statistics Canada, in 1968 there were 21 investments by new entrants from abroad into Canada and in 1969 there were 38, which made use of foreign funds in amounts of $0.5 million or more. These figures do not take into account any new entrants who would have raised most of their capital requirements from Canadian sources. Of the 21 new entrants in 1968, 12 were in the $500,000 to $1 million category and 9 were in the $1 million to $5 million range. Of the 38 entrants in 1969, 18 were in the $500,000-$1 million category, 15 in the $1 million to $5 million range, and 5 over $5 million. The gross inflow to the 38 new entrants in 1969 was approximately $80 million.

EXISTING FOREIGN CONTROLLED FIRMS

Table 58 contains an analysis of capital expenditures on plant and equipment by foreign controlled enterprises in Canada. It has been compiled on two different bases. The first column indicates the number of foreign controlled *enterprises* that spent over a certain sum on construction, ma-

chinery and equipment in 1970. The second column shows similar data classified by the number of *establishments* involved, based on capital spending intentions of single-establishment enterprises for 1971. (For example, the first column might show that the ABC Oil Company made total expenditures of more than $15 million in 1970 on construction, machinery and equipment. It would be classified as one of the 44 enterprises in column 1 that made expenditures of this magnitude or more. However, this might have been comprised of three expenditures of $5 million each by individual plants which the company owns. These three investments would appear in the $5 to $10 million group under the establishment figure). This table indicates, for example, that 58 individual enterprises made expenditures on construction, machinery and equipment each totalling more than $10 million and that 48 establishments (perhaps the more relevant figure) also made expenditures of that size. These expenditures are not necessarily all for expansions and no doubt include some expenditures for replacement and modernization.

TABLE 58

EXPENDITURES ON CONSTRUCTION, MACHINERY AND EQUIPMENT BY FOREIGN CONTROLLED ENTERPRISES*

($ Millions)

	(1) Enterprises		(2) Establishments	
	No.	Expenditure	No.	Expenditure
Expenditures†				
over $25,000,000	24	1,416	21	970
20,000,000	32	1,593	27	1,109
15,000,000	44	1,795	36	1,266
10,000,000	58	1,967	48	1,415
5,000,000	98	2,242	95	1,718
3,000,000	135	2,383	163	1,976
2,000,000	172	2,475	235	2,149
1,000,000	273	2,611	415	2,399

*SOURCE: Statistics Canada.

†1970 data for multi-establishment enterprises. 1971 intentions for single-establishment enterprises.

Table 58 indicates the number of establishments or enterprises which in 1970 made capital expenditures of more than a certain size. Table 59 covers *projects* valued at more than $1 million by foreign controlled companies. Its aim is to indicate how many major new investments are started annually. The table shows that during 1970 an estimated 211 projects were proposed, of which 57 were valued at over $10 million. While compiled from a different perspective, these data seem to be consistent with those contained in Table 58.

TABLE 59

PROJECTS VALUED OVER $1 MILLION PROPOSED BY FOREIGN OWNED/CONTROLLED COMPANIES, CANADA YEAR 1970*

Project Size Ranges ($ Millions)	Estimated Number of Projects
Over 100	6
75	8
50	19
25	36
10	57
5	114
1	211

*SOURCE: Department of Industry, Trade and Commerce.

From the data, it is possible to select a size criterion and determine the number of cases involved on an annual basis. Regardless of the dollar value selected as a criterion of economic significance for purposes of the jurisdiction of the review authorities, bargaining would probably take place in only a limited proportion of the cases.

Consideration could be given to reviewing takeovers and direct investment by new foreign entrants starting at a lower threshold than for existing foreign controlled firms because of the relatively small numbers involved. Moreover, in the case of takeover, there is considerably greater likelihood of a cost/benefit analysis coming out in favour of blocking or bargaining with the foreign investor, since Canada would have established its capacity to be in the industry.

Proportion of Investment Covered

Another measure of the degree of intervention that might be involved in a review process can be obtained by comparing Table 14 on gross fixed capital formation and Table 58 on expenditures on construction, machinery and equipment by foreign controlled firms.

Table 14 shows that gross fixed capital formation in Canada in 1970 amounted to about $18 billion. Only a little more than $9 billion represented expenditures by private business enterprises, other than for housing. The remaining $9 billion covered expenditures involving institutions, housing and the public sector.

Table 58 shows that the total of expenditures over $1 million on construction, machinery and equipment by foreign controlled establishments amounted to $2.4 billion in 1970. This $2.4 billion represents a substantial overstatement, since a significant proportion of these expenditures would probably be for investment in replacement equipment, etc., and would not

be covered unless the existing firms not undertaking new investments were to be screened. Thus one can assess, in general terms, the outside proportion of investment that the registration process would cover on the assumption of various thresholds for the review of new investment. In fact, a significantly smaller proportion would be covered if regular maintenance and replacement expenditures were excluded due to a decision not to review existing foreign controlled firms which are not engaging in major expansion—or to exclude existing foreign controlled firms entirely.

Regardless of the threshold selected, bargaining would take place over considerably fewer cases than those registered.

In selecting a threshold, account must be taken of: economic significance, the importance of some particular industries; widely different sizes of firms in different industries; administrative feasibility; and, importantly, the potential growth of firms which may be on the brink of major expansion with the next stage of their anticipated development.

Takeovers

It is very difficult to generalize about the contribution of takeovers to the growth of foreign control in the Canadian economy because of extreme variations in the value of takeovers from year to year.[5] For example, Table 11 shows that the value of assets acquired in any one year ranged from $4 million to $279 million in the period 1945-1961.

In 1968, as noted earlier, approximately 100 takeovers of Canadian enterprises with assets of $170 million were identified. In 1969 there were approximately 130 takeovers of companies having assets of $680 million. While these years are not strictly representative, they provide some indication of the changing pattern, since 1968 appears to have been a more or less normal year and 1969 an unusual year, involving several large takeovers—of which three alone aggregated nearly $400 million.

Of the growth in the total assets of foreign controlled non-financial corporations, takeovers accounted for around five per cent in 1968 and twenty per cent in 1969.

New Investment from Abroad

In 1968, 21 new companies involving foreign direct investment of over $500,000 were established in Canada. The corresponding figure for 1969 was 38 new companies. The gross inflows for these 38 companies established in 1969 amounted to approximately $80 million and accounted for about five per cent of the increase in book value of foreign direct investment.

The data available on the increase in foreign control, on the expenditures of foreign controlled firms, and on sources of funds, do not permit any accurate measure for the remaining categories of potential review, such

[5] See Chapter Five.

as investment by existing foreign controlled firms in new lines of business and drawings from Canadian capital markets—or from abroad—used for major expansion purposes. However, it is clear that takeovers and new investment from abroad account for a relatively small proportion of the increase in foreign control and that the bulk of the growth comes from the existing foreign controlled sector. This conclusion is confirmed by the data on the sources of funds for foreign controlled firms contained in Table 9 and the data on economic significance in Tables 57 and 58. Table 9 shows that if new direct investment were to be *entirely* excluded from Canada, foreign control would continue to grow in absolute terms, due both to the internal generation of funds by existing foreign controlled firms and to their ability to raise funds in Canadian capital markets. Tables 57 and 58 and the data on new direct investment in Table 59 show that the bulk of investments of large size originate with existing foreign controlled firms.

PERIODIC REVIEW

Consideration could also be given to the possibility of periodically re-examining the terms of entry into Canada. Conditions change and the terms set might no longer be compatible with Canadian interests. This is distinct from surveillance and enforcement of compliance with the terms set in agreement with the review agency which is discussed below. A policy which involved reviewing major investments of existing firms would obviate the need for this type of periodic review in at least some cases.

BARGAINING POWER

If the review agency is to be able to secure greater benefits from foreign direct investment, it must have substantial bargaining power. Consideration would therefore have to be given to empowering the agency to block any proposed foreign investment which it could review. In the case of takeovers, there should be no obligation imposed on the agency to approve a foreign takeover simply because no alternative Canadian buyer emerges.

In the manufacturing sector, Canada's bargaining strength has been reduced by the postwar decreases in the Canadian tariff and the declining importance of Commonwealth preferences, making trade a more feasible alternative to direct investment. Canada's main bargaining lever is now the size and affluence of the Canadian market, the extent of its cost competitiveness, and the foreign manufacturer's desire to enter and exploit it. Canada offers him a skilled labour force, a relatively stable political environment, and a relative wage advantage over the United States. Furthermore, Canada's proximity to the United States and its cultural similarities make Canada a

convenient and profitable extension of the United States market for United States-based firms. Similarly, other foreign manufacturers wanting to develop a Canadian market for their goods put some value on investment here in many cases. While Canada's bargaining strength in the manufacturing field is not overwhelming (nor equal in all sectors), there are undoubtedly some cases where it has not been fully utilized in the past.

Canada's bargaining strength is probably strongest in the resource-based industries, though it will vary from commodity to commodity, depending on the world supply/demand situation and other factors. Unlike manufacturing, where the foreign investor possesses the distinctive capacity, in resources the advantage is often in Canadian hands. Access to a stable long-term supply of raw materials is often an important consideration for a firm which has tied up large amounts of capital in processing and fabricating facilities, and has developed a global market position. Although it is unlikely that the review authorities will be able in the short run to change the location of processing and fabricating facilities in many instances, they may be in a position to bargain for the location of future expansion in Canada. If Canada were to insist that greater processing of natural resources must take place in this country, its action might induce some foreign countries to reduce the barriers they now maintain against imports of such resources in more processed form.

ESTABLISHMENT OF A REVIEW AGENCY

RELATION BETWEEN THE AGENCY AND THE GOVERNMENT

A review agency could be established as either an independent tribunal or an administrative agency responsible to a minister.

An independent tribunal could be required to apply statutory criteria (perhaps along the lines of those discussed previously), but perhaps subject in specific circumstances to a directive by the Governor-in-Council. Appeals might be authorized to Cabinet on matters of general principle or broad policy but not on the findings in specific cases. This would require the government to delegate a substantial measure of responsibility for decisions which would have great importance to its overall industrial and commercial policies to an independent body.

The responsibilities for negotiation inherent in the review process pose difficulties for an independent tribunal. It is not desirable for the government to delegate responsibility for these decisions to a body not directly responsible to a minister, and thus to Parliament and the people. Moreover, a tribunal that was independent of the government would not likely be able to muster as much bargaining power as the government itself.

If it were decided to opt for an agency responsible to Cabinet, the question arises whether it should report to a single minister or to a com-

mittee of Cabinet formally designated by statute. The designation of a single minister would focus responsibility for the operation of the policy. The minister would, of course, consult his colleagues in the case of important decisions. If it is thought that the decisions involved are too broad, and that they raise too many inter-departmental and regional considerations to be the responsibility of a single minister, consideration could be given to having him assisted by a committee of cabinet.

EXECUTIVE DIRECTION

If an administrative agency were established, the question arises whether it should be assigned to a minister in the course of his departmental responsibilities or a minister of state. In either case, if it were decided to have a statutory committee of Cabinet, the minister could be chairman of this committee.

ADMINISTRATIVE FUNCTIONS AND PERSONNEL

The agency would have to be staffed by personnel with a wide range of expertise. They would have to be fully informed about the government's economic and industrial objectives, and the operations of industry. They would have to include able negotiators who can command the respect of the private sector.

ADMINISTRATIVE PROCEDURES

The review process would require the development of appropriate procedures to perform a range of activities. A register of investment proposals would be maintained. Investors notifying the government of proposed transactions would file such information as was determined to be necessary for assessment purposes. Also required would be appropriate advice from various parts of federal government. Views of provincial governments could also be considered.

The first assessment to be made would be as to whether further examination or discussions were warrented. Notification of an intention to intervene on the part of the review group would be made within a certain period—possibly sixty days following initial registration by the investor. In the absence of such action within the specified period, the proposal could be deemed to have received approval.

In cases where further examination or discussions were undertaken, the government's position would be formulated in detail, and bargaining would take the form most appropriate to the circumstances of the particular case. Again, the best advice available in the government would be sought for the conduct of negotiations.

A decision to refuse permission to an investor would close the case. Publication of such a decision would be made, subject only to considerations of commercial confidentiality.

A decision to grant approval subject to certain undertakings would require techniques for recording the understanding upon which it was based.

The undertaking made by the foreign investor would necessitate some surveillance of the firm's actions to assure compliance and some capacity to enforce these undertakings. This would require statutory authority to compel compliance and to initiate various remedial steps. An investor would not be held responsible for non-compliance due to changing market conditions—although modifications of undertakings might be negotiated in such circumstances.

The agency would obviously have to make a first assessment of whether there was compliance. However, if it became clear that an undertaking was being evaded, a more formal decision would be necessary. The agency itself could be given authority to make this adjudicative decision, but this would involve the agency in interpreting an agreement to which it had been a negotiating participant. Alternatively, the matter could be brought before the courts. For purposes of court enforcement and interpretation, there would have to be written undertakings with the review authority. The credibility of the review process and its ability to realize the aims set out for it depend on a means of enforcing agreements.

FOREIGN GOVERNMENT INVESTMENT IN CANADA

One question that arises in connection with the review process is whether foreign *government* investment in Canada should be treated differently than foreign *private* investment.

In principle, it might be felt that investment by foreign governments should be dealt with on a different basis from that made by private foreign companies. There could be concern that foreign government investment would not be made wholly on economic grounds. In that case, a firm with foreign government participation in it might be less responsive to Canadian conditions, regulations or government wishes than other foreign controlled firms. A foreign government controlled firm might make a mineral discovery in the North, for example, but hold off exploiting it for years until its own national requirements called for development of those resources. On the other hand, large international firms, of the sort likely to be in a position to make similar investments, might well follow an identical policy.

There are a number of arguments for not adopting special procedures to deal with foreign government investment in Canada. Firstly, foreign government investment is not likely ever to become a major part of the Canadian economy, although it could conceivably become significant in one or two resource industries. Secondly, there are few types of information-

gathering activities that a foreign government could not attempt to pursue if it was intent on doing so by means other than those involving direct investment in Canada. Finally, the Canadian government may well have, at least in some instances, more leverage with investment by governments than with the head offices of most multinational enterprises.

It would be important not to draw an unreal distinction between purely government investment from abroad and the kind of investment that could be expected to come from countries where industry and government work very closely together. It should be recognized, for example, that investment from communist and some other countries is, in fact, government investment. Consideration might be given to establishing procedures to enable the government to scrutinize such investments before deciding whether to accept or reject them.

Accordingly, it would not seem necessary, in principle, to bar investment in Canada by foreign governments, but rather to treat it generally as any other investment. If a review process were adopted, this would provide Canadian authorities with the opportunity to consider whether foreign government investments in Canada would be beneficial to Canada's national interest. Moreover, consideration could also be given to empowering any review agency to require that companies which set up in Canada with foreign government investment waive any special rights or consideration or assistance that might accrue to them in any way in Canada as a result of the involvement of a foreign government.

FOREIGN EXCHANGE CONTROLS

A possible alternative to a review process would be the adoption of a system of foreign exchange controls, which, among other things, could be used as an instrument to regulate inflows of foreign direct investment funds. Such controls exist on the statute books of almost all western countries except Canada, the United States, Germany, and Switzerland, but they are not in active use in many cases. Some countries that do not have foreign exchange control legislation have in fact used the technique of influencing international capital flows quite extensively—for example, the United States.

An exchange control system, in its conventional sense, is basically a balance of payments mechanism. It would not be suitable for implementing many of the objectives set out in the previous discussion of the review process. While an exchange control system could be adapted to function as a review mechanism, it is a cumbersome and potentially costly method of achieving the government's objectives. Using exchange controls for this purpose inherently involves looking behind capital flows to consider the purpose they are intended to serve, which is part of the function of a review process. In the discussion below, the mechanics of a foreign exchange control, some of the purposes it could serve, and some of the difficulties and objections associated

with foreign exchange controls as an alternative to a review process, are considered.

As already noted, foreign exchange control is normally used to control payments to foreigners for balance of payments reasons. It can be used to control capital flows, invisible payments, merchandise trade, or some combination of these three. Normally, all receipts from exports and other sources must be surrendered to the control authorities. The available supply of foreign exchange is then allocated to various buyers according to certain criteria related to national needs.

A foreign exchange control agency usually authorizes certain private financial institutions to engage in foreign exchange transactions, subject to the rules which it sets down. In the case of Canada, the banks would probably be the sole institution authorized to conduct such transactions. It is the banks that now run the foreign exchange market. Under a foreign exchange control system, the banks probably would be legally required to implement exchange control regulations and to compile statistical data as needed by the control agency.

A foreign exchange control system, in its conventional sense, does not appear to be a viable alternative to a review process. It could not perform many of its functions, such as bargaining for better performance, blocking foreign direct investment in cases where there were no significant economic benefits for Canada, or searching for alternatives to direct investment. Furthermore, such a system could not take account of a foreign direct investor who sought to raise funds in Canada, nor could it review licensing and other forms of contractual arrangements. It could only relate to a foreign direct investor using Canadian funds (or to licensing arrangements) at a time when payments were made abroad. Attemps to influence the terms and conditions of the arrangements at this point would create difficult problems of retroactivity.

This does not mean that a review process could not be built onto a foreign exchange control system. This, in fact, is what has happened in many countries. Since almost all foreign direct investment involves some international transactions at some point in time, the foreign investor normally seeks prior approval of the foreign exchange control agency. The existence of foreign exchange controls then becomes a mechanism to trigger the bargaining process with the foreign investor. This bargaining can be done either by the agency or by other arms of the government. To the extent that prior approval is sought, the foreign exchange control agency is in a position to undertake a review process, with the threat of denial of foreign exchange as a sanction in the bargaining process.

Most of the problems associated with using foreign exchange controls as a method of controlling direct investment arise from the fact that exchange controls are basically designed to regulate the volume of payments to non-residents. Exchange controls are not concerned with factors such as the

level of activity in Canada, the level and quality of research and product development, or the degree of processing and export and procurement plans, all of which may be of concern to a review agency.

There are further problems associated with using exchange controls as a screening process:

(i) The existence of exchange controls would allow the exchange control agency to examine investments which involve international payments. If no international transactions were involved, the investment would not come to the attention of the exchange control authorities. From the perspective of the exchange control authorities, this would be of little concern, since the activity would then all be in Canada. However, if the exchange control policy resulted in the location of industrial activity in Canada for the purpose of avoiding international payments, there could be other costs involved. It is unlikely, however, that much foreign direct investment involving no payments abroad whatsoever would take place.

(ii) An exchange control mechanism to function as an investment review authority, should concentrate on capital flows and related current transactions. In practice, however, it is difficult to hive off the remaining block of transactions and make it subject to a general licence, e.g., arms length merchandise trade. Partial exchange controls are subject to a vast number of abuses. It is easy to disguise capital items as current payments. Furthermore, partial exchange controls are likely to result in more costly economic distortions than full-blown exchange controls, for resources tend to gravitate towards the opening in the system.

(iii) A review process would put the government in a position to intervene in the allocative process, but foreign exchange controls can be even more interventionist. For the reasons given above, foreign exchange controls would have to cover a broader range of international transactions than would a review process. The government would tend to become involved in the day-to-day decision making of a firm doing international business. As such, it would cause a reaction from the business community, representing as it might far more detailed intervention than a review process. In short, foreign exchange controls appear to be a blunt and inappropriate instrument for the task envisaged for a review authority.

(iv) Even if the foreign exchange authorities give general approval to certain types of current transactions consequent to approving a particular foreign direct investment, there is a risk that a full foreign exchange control system would frighten off foreign investment. This could include some foreign investment which Canada needs because of its accompanying technology or other distinctive capacities.

(v) The imposition of exchange controls limiting current international transactions would be inconsistent with Canada's International Monetary Fund commitments.

A traditional foreign exchange control system does not, therefore, appear to be a viable alternative to a review process because it is basically a balance of payments mechanism designed to control payments to non-residents. It could not perform many of the functions required of a review agency. A review function could be superimposed on a foreign exchange control mechanism, but this would be a cumbersome and indirect way of implementing the government's objectives in the field of foreign direct investment.

SOME ISSUES RAISED BY A REVIEW PROCESS

The proposed introduction of a review process in Canada, aimed at ensuring that foreign direct investment in Canada best serves the national interests, would undoubtedly raise a number of questions of concern from a variety of quarters. It is to be expected that such a proposal, representing as it would a significant new policy approach, would be subject to close scrutiny in the country at large and particularly by those whose interests might be affected by it, and in some cases would be regarded with considerable misgivings.

The adoption of a review process has important implications for federal-provincial relations, given the responsibility that each level of government shares for promoting growth and economic development. Although, much agreement on ends, there is always substantial room for disagreement over means. While the need for a national policy with respect to foreign direct investment in Canada, supplemented and reinforced by such measures as the provinces choose to adopt, can be strongly argued, some provincial governments may be concerned about the new use of federal authority. They might be concerned that a review process would be undertaken in such a way as to slow the growth of foreign investment, which they may count on heavily to support rapid economic development within their province, even though one of the basic purposes of the approach outlined in this study is to secure greater economic benefits from foreign investment for Canada as a whole and its individual provinces.

Among some members of the business community there might well be concern about the degree of intervention in the private sector represented by the review process and about the added element of uncertainty it would introduce (although both may tend to be exaggerated).

There might also be concern in some quarters about the difficulties confronting government in reaching the right decisions on the complex issues involved, about the danger of such decisions being subject to various pressures, and about the effects of the whole review process on the degree of

foreign ownership and control in the economy as a whole. Many of these issues reflect the traditional dilemma of reconciling the public and private interests. Some of the questions and concerns that might arise in response to the proposed adoption of a review mechanism are considered below.

FEDERAL-PROVINCIAL RELATIONS

There are a number of proposals in this study which relate to the interests of provincial governments, perhaps the foremost of which is the proposal, raised for consideration, of establishing a review process.

There are several reasons for federal-provincial consultation on the issues connected with this area of policy. These include:

(i) the many responsibilities which the provinces bear for their own economic development;

(ii) the practical need for provincial cooperation if the federal government's measures in respect of domestic control of the economic environment and industrial development are to have maximum effectiveness;

(iii) the general need for good working relations between the two levels of government.

All the provinces attach high priority to rapid economic development and are inclined to feel that Canada will continue to require a substantial volume of foreign investment to achieve this objective. This belief is held particularly strongly by those provinces which possess large mineral, forest and energy resources, and which have been vigorous in their search for investment funds.

For the provinces, foreign investment means an important source of economic development and jobs. It provides an alternative source outside Canada of capital and enterpreneurship. The extent of provincial policies, programmes and other undertakings that affect business and economic development is considerable, including: provincial and local taxes of several kinds; natural resources management (royalties, processing requirements, etc.); licences; land use regulations; industrial incentive grants, loans and guarantees; hydro rates; trunk and access roads (and, in B.C. and Ontario, railways); water and sewers; local pollution; labour laws; incorporation of companies; and securities transactions.

Some of these policies and programmes present possibilities for extending concessions to both Canadian and foreign investors. A major objective of a review process would be to maximize the returns to Canada from the foreign investment reviewed, which ideally would involve attempting to ensure that the assistance and support provided to foreign investors by the federal and provincial government did not go beyond that required to attract investment that would be beneficial. Since the review agency would not be able to do all this directly, it is clear that close provincial cooperation would be very important.

There are a number of aspects of a review process that could concern provincial governments. Some provinces may be fearful that the central government is creating an important new tool for influencing economic development at their expense. A review process could conceivably, depending on its coverage, partially circumscribe a province's ability to seek out foreign direct investment.

Secondly, to the extent that regional development objectives are to be included among the criteria, the more highly developed provinces might be apprehensive about possible discrimination against their interests. On the other hand, the East and West may worry about the review process as a device to favour the interests of Central Canada. It would, therefore, be very important to discuss fully with provincial governments the way in which the review process—if adopted—would operate.

Thirdly, some provinces may be worried about the uncertainty connected with a review process—that is, the uncertainty as to the vigour with which it might be used to bargain with the foreign investors covered by it, and the consequent risk of losing potential foreign investment. The question of uncertainty is discussed more fully below.

These objections could perhaps be met, at least in part, by taking steps to ensure that the provinces have the opportunity to play an important role in the development of policy in respect of the review process, and subsequently by involving the provinces in some form of continuing participation once the process is in place. Both these possibilities are discussed further below.

Given that the question of economic development is of prime importance in most provinces, there is a clear need to discuss the policy with the provincial governments.

In particular, it will be important to emphasize that a review process would only block investments which do not bring net benefits to Canada and to the provinces, and that its primary aim would be to obtain greater benefits from foreign investment, better economic performance and stronger growth of employment and real incomes in Canada.

Governments of provinces in which investment projects might be located could be advised of the foreign investor's proposal. In cases where the review authority does not intend to approve the proposal without further investigation, provincial views could be invited and an opportunity given for full discussion with provincial authorities before a final decision were made. In this regard, it is not unlikely that the province would be contacted by the would-be investor even before the application to the review group is made. Indeed, in some cases, the province might even have sought out the applicant.

The creation of a good working relationship between the review authority and the provincial governments could assist in coordination of provincial and national policies on industrial incentives and economic development generally.

It should be noted that a programme involving the concept of a federal review process could likely be worked out and put in place under one or more of the federal legislative powers contained in Section 91 of the *British North America Act,* including:

(i) The opening words of Section 91, that is, the power to make laws for the peace, order and good government of Canada in relation to all matters not assigned exclusively to the legislatures of the provinces. This general residual power of the Parliament of Canada seems clearly relevant because of both the international and national aspects of foreign investment, and because of its significance in relation to the maintenance of a national identity.

(ii) The regulation of trade and commerce under head 2 of Section 91. This head would seem to be particularly relevant where the activities to be reviewed involved international or interprovincial trade transactions by foreign investors. Furthermore, the programme would, by its very nature, set out the general criteria governing the trade transactions of foreign investors by which acquisitions of control are ordinarily accomplished.

(iii) Naturalization and aliens under head 25 of Section 91. Legislation under this head could prove to be important in the implementation of some of the alternatives put forward for consideration in this study, although, of course, it would only have application to persons who could be regarded, properly, as aliens. While a company incorporated in Canada, either federally or provincially, could not ordinarily be regarded as an alien itself, and while controls would have to be brought to bear in relation to the aliens associated with such companies, it is thought that the objectives of the review process could be achieved by Parliament authorizing the lifting of the corporate veil created by incorporation and the treating of companies subject to alien control as aliens for the purposes of the legislation. Such legislation would seem to be "alien" legislation or legislation ancillary thereto.

THE REVIEW PROCESS AND THE DEGREE OF GOVERNMENT INTERVENTION

The degree to which the review process would involve further intervention by government in the operation of the economy would depend upon the scope it is given and the type of foreign direct investment that would be subject to scrutiny and possible negotiation. It would be quite limited if the review mechanism were to cover takeovers. It would increase somewhat if screening were extended to cover investments by firms newly establishing in Canada. The addition of licensing arrangements and controlling contractual agreements would add a further dimension of intervention. A decision to review new investment by the existing foreign con-

trolled sector to one degree or another would significantly increase the extent of intervention.

To keep the issue in perspective, it should be borne in mind that federal government intervention in the economy is already substantial in many areas. Through general economic policies involving taxes, competition and monetary policy, federal authorities now play an active and important role in the operation of the economy. In a sense, they act more extensively on the economy than would a review process, in that they affect a far greater number of business decisions than would occur in the latter case. However, there is a very limited capacity under such general policies to provide for variations to meet individual circumstances. Government grant and loan programmes do involve a more specific form of intervention because of the greater discretionary power provided in their administration. Through such programmes the government is normally trying to remedy what it considers to be defects in the workings of the market place.

It would be desirable if both the business community and the public generally recognized that the basic objective of government policy in the field of foreign investment, as in many others, was to find a proper balance between maintaining the freedom of decision-making in the private sector to the greatest possible extent, while at the same time ensuring that private business decisions are compatible with the public interest.

THE ELEMENT OF UNCERTAINTY

One of the concerns likely to be raised in relation to a review process is that the criteria established as a basis for decisions are insufficiently precise, with the result that foreign controlled businesses would not be able to be certain in advance that their investment plans would be acceptable. The planning horizon of a business is often longer than that of governmental institutions. The businessman thinks in the long term and, to do this effectively, he wishes to see the environment as constant as is practicable.

The introduction of a review process—with the case-by-case approach—could add to the uncertainties always present in business's risk-taking activities. This is particularly true in the early stages of its operation. Any new policy of any government, no matter how widely it has been discussed, is a subject of interest and concern to all affected by it. The degree of uncertainty involved is reduced once the actual policy is known. The proposed review process raises another kind of question—the question of how the policy would be administered, since it involves a degree of case-by-case assessment and negotiation. In general, this uncertainty would diminish as experience with the process provided the public with a greater understanding of it. As the review group itself acquires experience, it might find it possible to establish in greater detail guidelines for particular sectors or transactions.

The review process could also encourage advance consultation on cases, which could be helpful to the potential investor, although some uncertainty is inherent in any potential bargaining.

The fundamental reassurance to anyone contemplating a new business risk, however, is that the review process need not be retroactive—the decision of the review authorities could precede the commitment of private resources to an investment.

And finally, it should be borne in mind that only transactions of defined significance would be reviewed; others would not be affected.

DIFFICULTY IN MAKING DECISIONS

The review authorities would have to make difficult decisions on inherently complex issues involving consideration of the impact of private business decisions on the public interest.

The Canadian government is already heavily involved in this sort of decision-making. Under existing assistance programmes such as DREE, PAIT, IRDIA and GAAP, the government requests companies to submit plans on exports, procurements, R&D, restructuring, financing, and other business variables. On the basis of these data, decisions are made as to whether government funds should be given to the applicant. These judgments often involve assessments of the capabilities of management, the value of a particular piece of technology, and the benefits to Canada from a particular project. Similar judgments have also been made in connection with the Automotive Adjustment Assistance program and the recommendations of the Textile Review Board. A government official is not by his training or experience precluded from recommending policies or from taking decisions involving business variables and benefits to Canada. However, his perspective is different. He is concerned with the public impact of these variables. The review agency would not attempt to substitute its judgment for that of the businessman on the business merits of a particular investment. Rather, it would examine the net benefits to the nation (applying the criteria described previously). Where feasible, the review authorities would try to increase the quantity or quality of industrial activity to be located in Canada. In reaching this judgment, the authorities would not have to know as much about a particular investment as does the businessman. They could have to know only what is required to allow the government to make a judgment on potential benefits to Canada. These judgments would only be made, of course, after considerable discussion with the parties involved.

In summary, it does not appear that the type of decisions required are beyond the capacity of a review agency. They are not easy judgments, but they are similar in kind to those made in relation to other programmes, to serve the interests of the economy and the Canadian people.

EFFECTS OF A REVIEW PROCESS ON THE DEGREE OF CANADIAN OWNERSHIP AND CONTROL OF BUSINESS

The thrust of the main proposals discussed in this study is to increase the net benefits from foreign direct investment and to improve the development of indigenous Canadian capabilities.

If a review process alone were implemented, and nothing were done to improve the industrial capabilities of Canadian entrepreneurs, the result might be a relative increase in efficiency in the foreign controlled sector. The degree of foreign control of Canadian business might, therefore, continue to increase to the extent that foreign investors were willing to meet the standards set by the review agency.

This does not mean that a review process would have no impact on Canadian ownership in particular cases. A review process would contribute to Canadian ownership and control by blocking foreign investments that do not make significant contributions to the Canadian economy, and through the possibility that viable Canadian alternatives to foreign takeovers might emerge. A review process would also contribute to Canadian ownership through its attempts to persuade would-be foreign investors to enter into licensing arrangements or joint ventures. However, in terms of impact on overall ownership patterns, such interventions would not have a great effect.

The main burden for increasing the degree of Canadian ownership and control in the economy falls on the various measures of a positive nature designed to support the development of Canadian entrepreneurship. Measures of this kind should, over time, reduce the need for foreign direct investment.

A more direct method of increasing Canadian ownership would be to add a protective dimension to a review process. This would involve at least short-term costs, particularly in the absence of a fully developed industrial strategy.

In summary, a review process by itself would not further Canadian ownership significantly, although it would add a new measure of Canadian control over the economic environment. However, in conjunction with improvements in positive policies, it would likely have a moderate effect in strengthening the degree of Canadian ownership and control over time.

Chapter Twenty Six

THE KEY SECTOR APPROACH

INTRODUCTION

One clear alternative to a national foreign investment policy based primarily on administrative intervention, undertaken through the kind of review process outlined in the previous chapter, is a policy based upon a "key sector" approach. Under such an approach, a number of particular areas or industries within the economy would be singled out to receive special treatment for a variety of economic and/or non-economic reasons. The nature of the special treatment accorded to these key sectors may cover a wide range, depending on circumstances. This, in fact, has been the approach generally followed in Canada up to the present time.

Usually a key sector policy involves some requirement for Canadian ownership and/or control within designated industries which may be widely varying in nature. Non-residents may be prohibited from holding more than a stipulated minority of the shares of all present and future enterprises within a particular field, as is the general rule now in the case of the chartered banks and broadcasting, for example. A requirement of this nature may provide an exemption for existing firms which have a greater degree of foreign ownership than the minimum stipulated, or it may cover all existing firms, or all which are Canadian controlled, but not apply to new entrants into the industry. Alternatively, an attempt to ensure the maintenance of Canadian ownership and/or control may also be made through indirect means, as is the case for newspapers and magazines.

The ownership requirements adopted as part of the key sector approach are usually based on the premise that it is desirable for a variety of reasons to have industries within those sectors directed largely or entirely by Canadians, rather than foreigners. In some cases, however, Canadian ownership may not in itself be regarded a sufficient guarantee in itself that the industry will perform in the way that is desired to serve Canada's national interests. In addition to the legislation restricting non-resident ownership of broadcasting in Canada, for instance, the Canadian Radio-Television Commission has established certain Canadian-content provisions for both radio and television, in addition to other requirements.

Provisions relating to ownership and/or control and to performance, as part of the key sector approach, can also be supplemented by a variety of other government policies and programmes to provide special assistance to a particular industry that may face some difficulty in surviving and developing under Canadian control.

While a foreign investment policy based on the key sector approach represents a basic alternative to one based on administrative intervention, the two are by no means mutually exclusive. The key sector approach could be adopted in a variety of different forms to complement and reinforce a foreign investment policy based primarily on a review process.

The adoption of a key sector approach as the main element of policy, however, could be relatively ineffective in achieving the desired goals and potentially costly in economic terms—in contrast to the review process—although this would depend to some extent on the sectors which were designed to remain under Canadian control. A key sector approach would not be a guarantee of sound economic performance. Canadian control does not in itself provide any assurance that a firm will operate efficiently, or that it will be any more inclined than one that is foreign controlled to pursue a course that may be considered most desirable in terms of the national interest.

Restrictive ownership rules applied to certain sectors could deprive Canada of foreign technology and other inputs that would be of significant benefit to the economy if these elements could not be acquired in any other way—perhaps under licence or through a joint venture—than through foreign direct investment. Such restrictions could also provide undue protection for Canadian business management and entrepreneurship, contributing to industrial inefficiency and perhaps to the need for the government to provide additional tariff protection or other means of compensating for the resulting inefficiency.

A key sector approach would not provide a readily workable instrument for ensuring that our industrial priorities are not distorted. There is, for example, no reason to be confident that Canadian controlled resources companies would undertake any greater degree of processing of raw materials in Canada than those that are foreign controlled—everything else being equal.

The study has suggested at a number of points that the dominant position assumed by the multinational enterprise raises particular problems in relation to foreign direct investment. The key sector approach, however, would provide only a limited means, at best, of dealing effectively with some of the problems presented by multinational enterprises that came within designated key sectors, but none whatever for dealing with those that were outside those sectors.

In contrast to the key sector approach, a review process provides an instrument for dealing in a more flexible way with significant problems posed by foreign direct investment wherever they may occur in the economy. But while there are compelling arguments against adoption of a key sector ap-

proach as the main element of a foreign investment policy for the future, there are some good reasons for considering its adoption in one or more forms as a supplement to a review process.

There may continue to be industries which it is desirable to single out for special treatment in a variety of ways for a variety of economic and non-economic reasons. Contrary to the general rule, there may be some industries in which there is reason to believe that Canadian ownership and control will contribute in a positive way to better economic performance. There may be some industries of such vital importance to the operation of the economy as a whole that there are overriding reasons in terms of the national interest to prefer their ownership and control to rest in Canadian hands. There may be other industries it is considered important to maintain under Canadian control for social and cultural reasons.

As already indicated, there are a number of ways in which the key sector approach could be maintained and even extended as part of a broader foreign investment policy based on a review process. For example, legislation establishing special provisions relating to ownership and other factors for industries which are now treated as key sectors could be maintained unchanged or amended some time in the future to establish revised ownership and other provisions. Furthermore, legislation could also be enacted to extend key sector treatment in one form or other to industries which are not covered at present.

In a sense, the application of a review process can itself, over time, indicate those industries which warrant protection as measured by its criteria. Industrial patterns can be expected to emerge from the work of the review process which indicates an *inclination* to preserve some sectors for Canadian control. Sectors identified in this way would only emerge gradually. There would not be any decision to "protect" these sectors without regard for their strengths and potentials, which could vary over time and in comparison with would-be foreign investors seeking entry through the review process.

The review process might be used more directly as a means of advancing a key sector approach in a variety of different ways:

(i) The legislation could direct the review authorities to take into account factors of social or cultural significance which were considered important.

(ii) The legislation, or regulations issued under it, could specify certain industries to which special preference for Canadian ownership should be attached in the review process—although remaining open to the possibility of foreign investment in some circumstances.

If legislation is introduced to require Canadian ownership or block foreign takeovers in a particular industry, the review process would not be needed.

As a general rule, the review agency should be specifically directed to be guided by economic considerations alone in determining whether any given areas of the economy should be singled out for some special kind of treatment.

In essence, a key sector policy is one which emphasizes a certain degree of Canadian ownership and/or control of Canadian firms. In contrast, the review process discussed above focused more upon the performance of firms. Under the key sector approach, "Canadian control" generally implies sufficient Canadian ownership of the shares of a company that the management effectively rests in Canadian hands, regardless of the percentage of shares that that requires. The ownership or control requirements may vary from industry to industry and they may be applied in different ways, as indicated earlier.

Unlike the alternatives discussed in the next chapter dealing with the desirability of a 50 or 51 per cent ownership of *all* Canadian firms of a significant size, the key sector approach focuses upon Canadian control only in respect of certain designated sectors.

Over the past fifteen years, the federal government has from time to time identified particular sectors of the economy which it determined to reserve wholly or partly for Canadian control. This policy has been based on the conclusion that there are certain sectors of such intrinsic importance to the nation economically or socially—or both—that it is either essential or highly desirable that the firms within that sector be wholly or largely under Canadian control. Underlying this approach is a belief that certain objectives of the Canadian government and people cannot be fulfilled satisfactorily without the presence of Canadian controlled firms in certain sectors of the economy.

To a substantial degree, these objectives have in the past been social or cultural, rather than economic. Thus, broadcasting, magazines, and newspapers have all been singled out for special treatment as key sectors[6], although there are substantial differences between the approach adopted in the case of broadcasting and that covering the print media.

Even the decisions to make the banks and other federally-incorporated financial institutions key sectors were not based entirely on strictly economic factors. For instance, the decision to treat the chartered banks as a key sector appeared to have stemmed in part from the fact that the Bank of Canada exercises moral suasion from time to time in its dealings with this institution. It was considered that foreign controlled banks might be less responsive to such suasion than those that are Canadian controlled. It was the continuing ability of the central bank to apply moral suasion effectively that was partly at issue, not simply the economic importance of the banks—although the latter was undoubtedly an important consideration.

Further study is needed to determine if some of Canada's non-economic objectives are being frustrated by foreign control in certain sectors. In particular, the publishing or production and the distribution industries related to books, magazines and films could be looked at from this viewpoint, as could all the communications industries.

[6] See Chapter Twenty.

A number of natural resource industries also merit study because this is an area of basic Canadian strength in which foreign inputs may have little significant contribution to make to the achievement of Canadian objectives.

Preserving Canadian control of the capital intermediation process appears to have been the main *economic* consideration that has prompted the designation of certain key sectors in the financial field to date. Federal authorities seem to have been concerned to ensure that the chartered banks did not come under the control of non-residents and that a Canadian presence was maintained in the case of federally-incorporated trust, loan and insurance companies. Their concern appears to have been based on the fear that non-resident controlled intermediaries would be more disposed to siphon an excessive amount of domestic savings out of the country than would Canadians.

Three considerations or criteria for identifying key sectors in the future are considered below. They involve the economic impact of foreign direct investment, the vital nature of particular industries and certain non-economic factors. Each of these is considered in turn. It is important, however, to recognize that these are not arbitrary criteria for determining which areas of the economy might be regarded as key sectors. Rather, they are criteria put forward only as a guide to help identify which industries warrant detailed study as possible candidates for designation as key sectors.

ECONOMIC IMPACT CRITERIA

The principle which could guide the government in determining whether the economic impact of an industry justified considering its classification as a key sector is that discussed above in the chapter on the review process. Basically the view expressed there was that consideration should be given to blocking foreign direct investment which would fail to have an impact that would yield a net economic benefit to Canada. It was also suggested that whenever indigenous Canadian capabilities were equal to or better than foreign capabilities, or whenever industrial development considerations prompted the government to provide special support to a particular sector, the objective of which could be frustrated more readily by foreign controlled firms, this could constitute sufficient reason for requiring Canadian control of that sector.

As noted above, the application of the review process criteria would lead to the singling out of some sectors where Canadian control would be more likely to emerge and be protected.

The determination of key sectors in this special sense through the review process, is more flexible than that adopted in the past. It is based on the assumption that the special status given a particular economic area could be withdrawn at any time if a foreign investor comes along with valuable new capacities or if the Canadian controlled firms become less efficient.

The essence of this kind of approach is that key sectors be determined, at least in part, by one of two major factors—or both. The first involves a comparison of indigenous Canadian and non-resident capacities in particular sectors of the economy over a period of time. Where Canadian capacities are equal or superior to those of non-residents, then rules could be developed involving a bias against foreign investment. This would simply flow from the decisions of the review process. Alternatively, these rules could take the form of regulations adopted under the authority of a general foreign investment law. In either case, it could always be made open to the agency to approve direct investment from abroad in cases where the foreign interests could demonstrate that they would make a significant contribution to the Canadian economy. If the protectionism inherent in ownership guidelines or regulations made Canadian controlled industry less efficent, causing a resultant loss in its comparative advantage, the guidelines or regulations could be modified to allow foreign controlled firms entry to provide a new competitive thrust. However, more rigidity would be introduced if each key industry were established by statute, which rigidity could, in turn, have costly economic consequence.

The second major factor involves industrial strategy. When the Canadian people have placed a large stake in an industry, they may wish to try to ensure the maintenance of Canadian control. Such control may help a firm to sink roots in this country and such roots may be needed to ensure that the firm in question is not subject to arbitrary decisions by those who are not particularly responsive to Canadian market requirements or Canadian government concerns.

VITAL INDUSTRY CRITERIA

The first set of criteria discussed above involved weighing the net economic impact of foreign direct investment on a particular industry or area to provide a guide to determining whether it should be classified as a key sector in the economy. In addition, however, there are industries which might be considered for designation as key sectors because of other economic factors involved relating to their very nature. These are industries that play a critical part in the functioning of the economy as a whole, a part that often extends beyond their importance in terms of size alone. Many have an important role in the determination and/or implementation of Canada's economic and social priorities. They could, for example, include industries in such fields as transportation, communications, power and certain financial intermediaries which have not been covered under present law—all of which are vital cogs in the economy. The fact that a particular industry or economic area meets this criterion does not provide grounds for its automatic designation as a key sector, but it does provide grounds for further study in depth to provide the basis for reaching a judgment as to whether all the relevant factors justify such a step. Such an approach would be feasible whether or not it were decided to adopt a review process.

The kind of industries which might fall into this category are, in a sense, part of the central nervous system of the nation and as such are a matter of concern for several reasons. Firstly, the government may wish to have some capacity to exercise moral suasion over them from time to time because of the vital role they play in the operation of the whole economy. For instance, a disruption of rail service or of electrical power distribution can cause economic problems many times greater than the dollar value of the service cut off. In such situations, the government may wish to intervene by dealing directly with the senior corporate officials. Using moral suasion in such situations is more difficult with foreign controlled firms, as the government normally has less leverage with them than with those controlled by Canadians.

Secondly, the government may wish to maximize the capacity of Canadian regulatory authorities to obtain good cooperation from firms in an industry. In this situation, Canadian control may be helpful. Finally, in such industries it may be important to have senior corporate officials who are fully sensitive to the Canadian economic, political and cultural environment. This again is achieved most easily, though by no means assuredly, by Canadian control.

It is not concluded from the above that any firm which is in a particular important industry not now designated as a key sector need necessarily be subject to Canadian control in the future. In some cases, public regulation may be sufficient. It is, however, suggested that any industries which fill this very important role in the economy must be examined case by case to consider whether the facts of the particular situation do seem to warrant Canadian control.

NON-ECONOMIC CRITERIA

There are some areas of the economy which might be considered for designation as key sectors for reasons unrelated to economic factors. These are areas which play an important role in terms of safeguarding or developing Canada's culture and identity, in terms of other social considerations, or in terms of national defence and security.

CULTURAL CONSIDERATIONS

With respect to those industries which have an important role in the safeguarding and development of Canadian culture and identity, several considerations seem to be relevant. The first is that the total reliance upon foreign controlled firms in industries such as the publishing and distribution of magazines and books leaves open the possibility that these firms will serve as vehicles for excessive intrusion of foreign culture at the expense of the development of Canadian culture. If this were taken to an extreme, the consequences for indigenous cultural development and preservation of a distinctive identity would be highly adverse. This does not mean that if foreign controlled firms do dominate, the worst would necessarily happen.

Rather, it means that there is a risk of foreign cultural domination which may be too great to take.

The converse situation is, of course, one where only Canadian controlled firms are allowed in cultural activities, and, in the extreme, where all imports of foreign books, films, magazines, and works of art, etc., are prohibited, thus insulating Canada from the rest of the world's creative output. This extreme is equally undesirable and obviously does not provide the basis for an acceptable Canadian cultural policy.

Between these extremes, there is room for much debate and argument about the appropriate role for the foreign controlled firm in Canada. At the same time, however, it must be recognized that any rationale for either a restrictive or open ownership policy would be more difficult to develop in the absence of further elaboration of government policies on cultural development.

National Defence and Security

A further issue for consideration is whether there are reasons of national defence or security that make it important for certain Canadian industries, such as those involving defence equipment or resources, to be Canadian controlled.

The question of foreign government and non-western ownership of Canadian business was considered earlier in the study. The question at issue here is whether there are reasons of national defence or security which argue against the nationals of other western countries being able to own and control certain categories of Canadian business. When viewed in this way, the question is whether Canada should restrict the ownership of defence industries or resources important for defence by private firms controlled in countries with which Canada is now allied militarily. As most Canadian defence equipment and resource industries are already foreign controlled, any significant move to establish Canadian control would require extensive acquisitions to be made of foreign interests.

However, nothing in the government's reviews of foreign or defence policy suggested that a programme of buying back such industries need be undertaken for reasons of defence or security.

Other Non-Economic Factors

There may be other non-economic considerations, in addition to those already discussed, which should play a part in the determination of key sectors.

One such consideration involves the matter of personal privacy and the confidential nature of certain kinds of information. This issue arises out of the growing use of data banks and the lines along which information is transmitted. It seems desirable, as a matter of principle, that the confidentiality of private information relating either to individuals, companies or other groups should be maintained as fully as possible. To the extent that the extra-territorial application of a foreign law or policy, including political pressure

of a foreign government, could endanger such privacy, Canadian control (as well as public regulation) may be needed. It may also help to prevent the misuse of information about Canadians compiled and stored by foreign controlled data collecting companies. Partly for these reasons, computer utilities and data banks need to be examined from this perspective.[7]

CONCLUSIONS

A foreign ownership policy based largely upon the concept of key sectors is one which is likely to carry a greater risk of being economically costly because of its more rigid and arbitrary nature than one based upon a review process. It also gives the government less capacity to influence the domestic economic environment than does a review process, since ownership itself does not provide sufficient assurance that performance goals will be achieved.

At the same time, there may be a limited role for a key sector policy as a supplement to a review process or as part of a review process. The three kinds of criteria discussed above may be useful in helping the government to identify which areas or industries should be considered as key sectors if it were decided to adopt this type of approach. These factors are not exhaustive nor can they be applied in a mechanical way, in the sense that they do not predetermine which sectors would be designated as key sectors, but they do indicate those that merit special study to determine if they should be so designated.

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[7] This issue is at present being considered by the Joint Task Force on Privacy and Computers established by the Departments of Communications and Justice.

Chapter Twenty Seven

THE FIXED RULES APPROACH

INTRODUCTION

Another alternative policy approach to the problem presented by foreign direct investment is to make it mandatory for Canadians to own a certain proportion of all firms in Canada of economic significance. It could be provided by law that Canadians be required to hold half (50 per cent) or a majority (51 per cent) of the voting shares of such Canadian companies. Such an approach has been adopted in certain other countries.

Legislation could also be enacted requiring that a specified minimum proportion of the directors of all economically significant companies in Canada be Canadian citizens ordinarily resident in Canada. Such a provision could serve either as a complement to mandatory Canadian shareholding requirements or could be instituted independently on its own merits. In the latter event, however, the policy would probably not have sufficient impact to be considered as a broad alternative to the options discussed earlier, but would have to be viewed only as a small part of a general policy on foreign direct investment involving other, more substantive measures.

This chapter is devoted to examining some of the factors that should be taken into account in giving consideration to the desirability of adopting some form of fixed rules governing the bulk of foreign controlled companies in Canada.

MANDATORY CANADIAN SHAREHOLDING AND JOINT VENTURES

Legislation requiring that Canadians hold a half or more of the voting shares of all companies of economic significance in this country would undoubtedly bring about a very substantial reduction in the degree of foreign ownership of Canadian business enterprise. For this reason, such a policy constitutes a clear alternative to the other general approaches discussed earlier —a review process and designation of key sectors.

Legislation providing for minority Canadian shareholdings, or aimed at encouraging the achievement of this objective, constitutes a variation of this

approach. This variation, however, is not likely to have sufficient impact to provide the basis for a general foreign investment policy.

Like the key sector approach, but unlike the review process, a policy based on fixed ownership rules assumes a certain real benefit is acquired merely from obtaining Canadian ownership per se, or at least in obtaining some degree of Canadian owership. That is, the premise of these two approaches standing alone is different than that on which the review process is based.

ALTERNATIVE APPROACHES TO MANDATORY CANADIAN OWNERSHIP

Provision for mandatory Canadian shareholdings could be made in a number of different ways. Following is an outline of four alternative approaches that might be adopted. These options are put forward only to indicate the range of possible approaches.

Mandatory Joint Ventures

One possibility is to provide by law that all foreign investors in Canada be required to have a Canadian partner holding at least 51 per cent of the voting stock, or, alternatively, a significant minority of the shares—perhaps 40 per cent, and entitled to elect directors in proportion to his share of voting stock. This would constitute a joint venture by the foreign and Canadian interests. Such a joint venture would ensure substantial Canadian equity participation and help to obtain an important Canadian voice in the management and direction of the company.

Under this approach, all of the shares held by Canadian citizens would be concentrated in the hands of one Canadian firm ownership interest, so that the foreign shareholding would not necessarily be the largest single concentration of shares (as would be the case if the law provided only for 50 or 51 percent Canadian ownership, but with the possibility of the Canadian shareholdings being fragmented). Even if the foreign interest were the largest single ownership interest, there would likely be significant Canadian participation in the management and proceeds of the venture. The joint venture approach raises a number of questions in the context of various issues that are of prime concern in this study, some of which are considered below.

Domestic Control of the National Economic Environment

Sufficient control of the national economic environment is needed to provide the means of ensuring that the Canadian economy is responsive to public policy. Would mandatory joint ventures enhance domestic control by making such firms more receptive to the Canadian environment and requirements of public policy?

It was noted on a number of occasions earlier in the study that Canadian control of a firm is not always an indication in itself that a firm will perform

well economically, or otherwise be responsive to Canadian policies. In other words, requiring foreign firms to enter into joint ventures with Canadian partners does not ensure that domestic control will be improved in all cases.

Certain aspects of domestic control are likely, however, to be improved through the technique of joint ventures. The existence of a Canadian partner would restrict the ease with which assets, product lines or profits of a firm could be arbitrarily moved out of Canada without due consideration of Canadian policies and needs. A Canadian partner increases the sensitivity of the firm to the Canadian economic and social environment. Joint ventures would also be less likely to serve as vehicles for the transmission of foreign laws and policies to Canada than would be the case with firms which are wholly or largely foreign controlled.

At the same time, it must be recognized that joint ventures whose operations are largely international in scope may be heavily influenced by circumstances and pressures abroad and thus be under some compulsion to respond to foreign laws, policies and priorities.

Truncation

One important consideration noted earlier was that foreign control often involves truncation of the activities of the subsidiary, making innovation at this level very difficult. This in turn reduces the scope for the development and exercise of entrepreneurship in Canada. It also has an adverse impact upon employment, since the less truncated the operation, the more jobs it will tend to offer.

The question that arises is whether the existence of a joint venture tends to increase both the capacity and incentive of the foreign investor to truncate the operations of the Canadian firm.

Where a joint venture is the result of normal market forces and conditions, or modest tax incentives, it is likely that the answer would be in the negative. Voluntary joint ventures (as opposed to mandatory joint ventures) generally bring together parties which have something to offer one another (such as one having a new technology and the other the marketing outlets). In such circumstances, the assumption is that there is some balance of bargaining power, with the Canadian partner having the capacity and desire to press for the undertaking of a less truncated operation in Canada where it was profitable to do so. Even this kind of relationship involving a voluntary joint venture, which initially provided for a reasonable degree of Canadian industrial activity, could be altered significantly if rapidly changing technology or other dynamic factors disrupted the balance between the two partners and made it more profitable for the foreigner to undertake more of his activity abroad or on his own.

Conversely, the adoption of a mandatory Canadian ownership policy could incline a foreign investor to establish a more truncated operation in Canada than if he could retain full ownership himself, the degree of trun-

cation perhaps depending in part on whether or not the Canadian rules permit him to retain effective control. The aim of such an investor would likely be to maximize his return on a minimum capital investment. This would be particularly so if this mandatory approval were to be applied to a foreign investor having some valuable distinctiveness as well as access to capital and other inputs—while the Canadian participation could only be justified by the legal requirement. He would normally prefer to make his larger investments in other countries, or firms where he was not obliged to offer shares to foreign nationals and where he was able to retain all or the greater share of the profits.

In the case of mandatory joint ventures, there would obviously be many cases in which the apparent balance between the Canadian and foreign partner would only be superficial from the beginning because many Canadians entering such an arrangement would have little to contribute. In that kind of situation, the foreign investor would attempt to minimize his contribution to the deal by undertaking as little activity as possible through the joint venture and as much as possible through his own operations abroad. The extent to which a foreign investor would be able to truncate his Canadian operation as a response to mandatory Canadian ownership requirements (or to changing circumstances) might be circumscribed by a review agency (if the joint venture approach was not made the sole vehicle of the foreign investment policy) which could bring its own negotiating powers to bear in an effort to ensure that a reasonable proportion of the industrial activity is undertaken (or maintained) in Canada.

In summary, compulsory joint ventures are likely to result in a very strong incentive for a foreign investor to truncate in order to share as few of the proceeds of the activity as possible, with all the adverse consequences this implies for the Canadian economy. Nevertheless, joint ventures do provide some opportunity for Canadians to participate in benefits, management and direction of the company and to acquire experience in the managerial roles in industries formerly dominated by non-Canadian interests.

Economic Efficiency

Any legislation requiring all foreign firms in this country to have a Canadian partner would almost certainly result in some reduction of foreign direct investment in Canada, whether for new ventures, expansions or acquisitions. As a result, Canadian controlled firms in some industries might be under less competitive pressure if some firms did not enter the Canadian market and perhaps be less likely to operate efficiently. Those joint ventures which were undertaken in compliance with the legislative requirements would be less likely to be rationalized on an international basis, since the foreign participant would limit the extent to which he integrated such a joint venture with his global operations, and therefore would be less likely to realize their potential for greater efficiency in some industries. As an alternative

to foreign direct investment, however, some companies might seek to supply the Canadian market to a greater extent through exports, which in some cases could maintain the competition for Canadian controlled firms.

Absence of Selectivity

In one respect, mandatory joint ventures would have the opposite effect of a review process. The essence of a review process is that it is selective. By applying the case-by-case method, it would be able to take into account the economic consequences of its intervention. By contrast, general ownership rules respecting joint ventures, if made to apply across all industries and in all circumstances, would not be selective. For this reason it is not possible to anticipate what their general impact on the economy would be. But the impact is likely to be adverse in some settings and unlikely to serve the variety of other objectives of industrial policy.

For one thing, some investment that offered advantages to the Canadian economy—perhaps in the form of new technology or new export markets—would be lost, since some foreign firms would be reluctant to invest if they could not exercise full control. In particular, they might be concerned about revealing the secrets of their distinctive capacities—for example, those involving technology or know-how—to a Canadian partner.

Furthermore, to avoid sharing the profits with a Canadian participant the foreign firm would probably prefer to locate any new plant capacity in places other than Canada, especially if the plant is to do more than supply the Canadian market.

Thirdly, if a mandatory joint venture provision was made retroactive, foreign controlled firms would hesitate to invest in new capital equipment. They would seek to minimize their investment in Canada. They would think twice about upgrading their machinery and plants.

Fourthly, mandatory joint ventures applying across the whole economy assumes that Canada has equal indigenous capabilities across all industries, that Canada would be equally able to fill the breach in each sector. This is clearly not the case.

Finally, it will be evident to the foreign owner that our capabilities are weak in some areas. This, in turn, will leave him in a strong position to demand that a Canadian partner pay heavily for whatever minimum share he is required to be given. At some price, such an enterprise would become a bad deal for Canada.

In short, such an approach would take no account of the selectivity likely to be necessary to implement a sound industrial development strategy.

Other Factors

Some of the arguments in favour of joint ventures are supported by the analysis in this study. The advantages, however, are ones which in some cases can also be achieved through other techniques.

For example, it is suggested elsewhere in this study that there may be an inadequate supply of Canadian stocks of satisfactory quality for Canadian buyers, especially institutional buyers, that this shortage is contributing to the large investments of Canadian portfolio capital abroad, and that this increases reliance on foreign investment.[8] It is sometimes argued that legislation which would have the effect of making a greater volume of shares available in the Canadian market would provide the additional investment opportunities in Canada required by large institutions, and that they would thus be less likely to invest abroad.

If joint ventures were made compulsory, there would tend to be an increase in the volume of shares available in the Canadian market and there might be some improvement in the quality of the available shares, as some Canadian participants in joint venture might raise a part of their money through the stock market; that is, the objective of increasing opportunities for investors to put their money in Canada would be advanced.

While a mandatory joint venture requirement might be conceived of as a means of improving Canadian capital markets, there are other and perhaps better techniques for improving the efficiency of these markets, as indicated earlier in the study.

It has also been asserted from time to time that requiring Canadian shareholdings would force foreign controlled firms to disclose more information about their operations than they now do. While this is quite true, it is a very indirect means of achieving that end. Elsewhere in this study, means are suggested which would deal more directly and comprehensively with this need.[9]

It is also sometimes suggested that mandatory Canadian ownership provisions would require firms to take greater account of Canadian interests than is now the case. To a limited degree, this may be true in some instances. However, the review process would provide a more direct and effective means of achieving this objective, as well as a number of other objectives.

Conclusions

Apart from the symbolic act of reducing foreign control, the economic benefits flowing from a general requirement of joint ventures would likely be limited at best. The costs could be significant in economic terms, with some needed investment being lost and probability of truncation increased. There might be greater inefficiency in Canadian management. While a mandatory joint venture provision does not appear realistic, it might be desirable to consider directing a review agency to press for the establishment of joint ventures in those situations where such an arrangement would be feasible.

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[8] See Chapter Seven.
[9] See Chapter Twenty Two.

Majority Canadian Ownership and Director Representation

As a second option, the law could provide for 51 per cent (or more) Canadian ownership of voting stock, in *all* Canadian firms, or all firms of significant size with the possible additional requirement that directors be elected separately by the Canadian and foreign shareholders. If it were required that the directors be elected separately by Canadian and foreign shareholders in proportion to the size of their respective shoreholdings, the directors chosen by Canadian shareholders would always be in the majority. The details of such a scheme could be altered, but the concept is clear. The law would both provide for Canadian ownership and, while not ensuring Canadian control, increase substantially the likelihood of control being achieved because it would allow any group of Canadian shareholders who could obtain the support of half the Canadian shareholdings—25.6 per cent of the total voting shares—to be able to control the board of directors.

It would, of course, also be possible for the foreign affiliate to persuade a Canadian shareholder to nominate a slate of Canadian directors sympathetic to the foreigner's position. The foreign affiliate might have the capacity to mount a campaign to secure the election of the slate of Canadian directors in which it had confidence. But this would not necessarily happen. Under the option postulated here, it would always be feasible for control to be gained by a Canadian group which wished to build the subsidiary into a firm that was more independent of the existing foreign parent. It would, similarly, be possible for such a Canadian group to exert pressures to ensure that the profits earned by the subsidiary were reported as Canadian profits, rather than as profits accruing to the foreign affiliate. The foreign investor would be conscious of this. He would recognize that his hold on the Canadian firm was not a sure one.

This approach is thus similar to the point venture involving 51 per cent (or 50 per cent) Canadian ownership. It differs in that it does not ensure that the Canadian ownership would be concentrated, even though it does leave open this possibility.

In assessing the implications of this approach for the various issues which are of concern in this study, much of the analysis which applies is similar to that which was set out in the assessment of mandatory joint ventures.

The foreign investor would recognize that he would be entitled to only 49 per cent (or 50 per cent) of the profits. He would also recognize that his capacity to benefit in other ways would be threatened by the possibility of Canadian control.

Thus the incentives to truncate would be similar to that described in the first option involving mandatory joint ventures. The likelihood of reduced foreign investment would probably be as great, thus increasing protectionism and jeopardizing economic efficiency. The lack of selectivity would simil-

arly involve a large economic cost. The arguments, in short, would be equally against such an approach and perhaps more so if Canadians do not exercise control.

Majority Canadian Ownership Alone

The third option involves legislation providing for 51 per cent Canadian ownership, but without any provision for separate election of Canadian directors by Canadian shareholders. In most cases, this would involve continued foreign control.

The implications of this approach are somewhat different than the first two alternatives.

Domestic Control of the National Economic Environment

With continued foreign control of the firm, the likelihood of greater domestic control of the economic environment would not be very great. However, the existence of large Canadian shareholdings would, as a practical matter, require most firms to provide for a number of Canadian directors. It might also lead to a greater consciousness of Canadian interests. But the firm would not be as hampered in moving profits out of the country as it would be if there were an effective Canadian partner and it would probably remain no less exposed to pressures and laws of foreign governments. Thus, while some increase in domestic control might be felt, it would probably be relatively small.

Truncation

The incentive to truncate would be as great as in the alternatives considered above. But, if anything, it would be easier to carry out because a Canadian partner or directors elected separately by the Canadian shareholders would not be present. Thus fewer obstacles to such practices would exist.

Economic Efficiency

Foreign investors would likely be much more ready to invest in Canada in this kind of situation than in the two discussed above. They would be virtually sure of retaining control. Accordingly, this kind of approach would probably deter fewer foreign investors than the first two options and would be less likely to protect inefficient firms from the competition offered by foreign investors.

Significance for Canadian Control

To require all foreign controlled firms to make available 51 per cent of their shares to Canadians would, in turn, require that Canadians put up

very large amounts of equity capital. This could make it more difficult for existing Canadian controlled businesses, and those that have a potential to develop in future, to raise equity capital—at least for a substantial number of years. It is thus possible that the greater Canadian ownership which would result from this option would also lead to less Canadian business control. As pointed out in the discussion of mandatory joint ventures involving a Canadian partner which was a public company, this approach would, however, to some extent satisfy the shortage of shares available in Canadian capital markets.

Conclusions

It is sometimes argued that, apart from its symbolic benefits, a requirement that a majority of the shares of all firms in Canada be owned by residents would help to set a cumulative process in motion by which Canadians would come to assume an increasingly important role in the management and direction of enterprise in this country. Against this possibility must be set the likelihood that such a requirement would result in substantially greater truncation of the operation of those companies in which foreigners retained an interest, and also the likelihood that achieving a further increase in effective Canadian control of firms in this country would be endangered by the fragmentation of Canadian capital.

Minority Canadian Ownership

Under this fourth option, Canadian law could provide that all foreign controlled firms must have at least minority Canadian ownership of voting shares, say a quarter or a third.

Two objectives might be served by such a law. Firstly, increased opportunities would be made available to Canadians to invest in Canadian firms. Secondly, greater Canadian ownership might in turn lead to election of more Canadian directors and officers, with the possibility that the subsidiaries would become more sensitive to the needs of Canada and more responsive to the Canadian environment and public policy.

The same objections that were cited above in respect of the 51 per cent Canadian ownership option (option three) would apply also here. The incentive to truncate would remain though it would not be quite as great as in the case immediately above. Canadian controlled firms wishing to raise equity capital might also face increased difficulties, although not as many as if majority Canadian ownership was required.

PROBLEMS IN ESTABLISHING SELLING PRICES UNDER MANDATORY OWNERSHIP RULES

If a law were enacted requiring existing foreign controlled firms to make shares available to Canadians, it would be necessary—as a practical

matter—to allow a fairly long period of time for its implementation. If this were not done, there would be a flood of shares on the Canadian market which inevitably would exceed the demand for such shares. The likely result would be that the price per share would be substantially lower than a realistic market value. In turn, this would be likely to lead to strenuous opposition from the foreign controlled firms, with the support of their home governments. There would also be strong objections from those Canadians who were already shareholders in such companies. The Canadian government might then have to step in to establish appropriate values—never an easy task—to prevent a conflict developing with our major trading partners and to satisfy any existing Canadian shareholders.

A further consideration is that a Canadian investor's view of the value of the shares of a Canadian subsidiary is likely to be different from that of the parent firm if the Canadian ownership provisions should lead to a weakening or severing of the links between the parent and the subsidiary. It was suggested earlier that the subsidiary, especially in manufacturing, is often very heavily dependent upon the parent's technology and know-how. It is tied closely to the parent's strategy and capable of contributing to it. The value of the Canadian subsidiary could be substantially altered if those links were not fully maintained.

All four options considered, however, would be likely to involve a change in the relationship between the Canadian firm and its foreign affiliate in a way that might have an adverse impact on the profits of the Canadian firm. After the change in the relationship, the foreign firm could be expected to insist upon full value for goods and services it provides to the Canadian firm, whereas when it previously owned 100 per cent of the Canadian firm, it may not have been doing so. This would further complicate the establishment of a fair price. On the other hand, the opposite may have been true, with the parent over-charging the subsidiary for the goods and services it supplied. In this case, Canadian interests might press for a better deal, which could be a factor that would tend to enhance the profitability of the Canadian operation.

In the case of the first two options, under which the foreigner might not be in complete control of the Canadian business, there might also be some difficulty in persuading the foreign affiliate to make available to the Canadian firm the most up-to-date and most valuable technology and other inputs which it possesses. The reluctance to locate a full range of activity in Canada would reflect the fear that confidential commercial information might become available to Canadians whom the foreigner does not effectively control. Under all four options, the foreigner might be similarly reluctant to locate activity in Canada because of his desire to minimize the flow of profits to Canadian shareholders.

In any case, the implementation of the mandatory sale of shares to Canadians would have to be spread over a good number of years to allow

the market a better opportunity to set the value fairly and provide the capital with which to absorb the securities involved.

CONCLUSIONS

The weight of evidence and argument appear to be strongly against any approach based upon mandatory Canadian shareholdings. Apart from the symbolic value of a gesture requiring Canadian ownership, such benefits as might be obtained would be very small. The economic costs involved would vary from one option to the other, but in all cases they could be substantial because of the arbitrary and general quality of the rules. Accordingly, the analysis does not suggest such an approach.

There is one additional possibility that could be considered if it were decided to implement a review process. That is to authorize the review agency to consider the degree of equity participation that would be made available to Canadians as one of the factors to be weighed in deciding whether to approve foreign direct investment.

Some of the arguments outlined above with respect to mandatory Canadian shareholdings would apply also in the case of this alternative approach, especially the concern that this would increase the likelihood of truncation. However, a review process could take this into account, and could avoid or substantially reduce the risk of such a development by using the technique selectively and with flexibility, considering for each case the probability of producing such negative results.

Another factor which might decrease the likelihood of such negative side-effects as truncation resulting from this alternative approach is the possibility that such firms would appoint external Canadian directors, that is those who are not officers or employees of the subsidiary, or otherwise linked to it in a business relationship—such as legal counsel or fiscal agents. Indeed, if some priority is given to having Canadian shareholdings, then equal priority should be given to requiring Canadian directors. This could result in greater sensitivity to the Canadian environment.

CANADIAN DIRECTORS

INTRODUCTION

While the issue was touched on earlier in this chapter, it is necessary to consider in greater depth the question of whether special rules should be developed to encourage or require foreign controlled firms to elect Canadian citizens ordinarily resident in Canada to their boards of directors. In considering some of the possible policy alternatives outlined below, a number of factors must be taken into account.

A major consideration that arises is whether having Canadians on the board of directors of a subsidiary would enable the interests of the subsidiary to be asserted more forcefully within the international firm than it would be without them. The interests of the subsidiary do at times differ from those of the parent. On occasion, the subsidiary will want to argue forcefully its position with the parent firm. The existence of external Canadian directors could be of some importance in such situations, especially as existing boards of directors of subsidiaries are often made up of internal officers or other closely associated with the subsidiary, who may not always be in a position to take as firm a stand.

Where Canadian minority shareholders also exist, an even greater weight would likely be given to the views of Canadian directors by the parent firm. On the whole, however, the capacity of any board of directors of a subsidiary to convince a parent may be limited when there is a real difference of interest. Thus the benefits to be derived are likely to be modest.

A second consideration relates to the role of directors under company law. The Department of Consumer and Corporate Affairs is now considering further revisions to the *Canada Corporations Act* which would make directors more directly responsible for the affairs of a company and consequently oblige them to take a greater interest and participate more actively in its affairs. This could also tend to enhance the value of having Canadian directors.

APPOINTING GOVERNMENT NOMINEES TO BOARDS OF DIRECTORS OF LARGE MULTINATIONAL FIRMS

Chapter Four drew attention to the power and flexibility of the multinational enterprise. In particular, it was pointed out that there are occasions when the interests of the Canadian subsidiary and that of the MNE as a whole will differ. It was also noted that there are times when the subsidiary will seek to convince the parent of the merits of undertaking an investment or other activity in Canada.

It is often maintained that Canadian directors on the boards of foreign controlled companies can play a useful role in helping to protect and promote Canada's interests in the operation of the enterprise. If this view is valid, then the logic of the position suggests there is some merit in considering whether the government itself should be empowered to appoint some directors to the boards of the larger and more economically significant MNE's operating in this country—perhaps those with assets of more than $50 million—to represent the broader public interest of Canadians.

The function of government appointed members of a board of directors could be the same as that of any other Canadian director, but there would be much greater assurance that they would not simply be an instrument of the parent company, but free to argue for and defend the interests of the Canadian corporation. The purpose of such an appointment would not be to secure a

director who would report back to the government on the corporation's affairs, but to assure an active and independent Canadian voice in the affairs of these companies.

To achieve still greater effectiveness from government appointment of Canadian directors, it might be desirable to have a means available for the public expression of their views from time to time. Where a director felt that the interests of the Canadian subsidiary were not being fully protected, he would be free to present his view publicly. Short of this, the only course open to a government appointed director would be resignation.

Providing for appointment of some directors by government would be a recognition of two factors: firstly, that the Canadian subsidiaries can and sometimes do have interests which differ from those of their parents; and secondly, the important role of subsidiaries in the Canadian economy.

As a way of improving the net benefits to Canada from foreign direct investment, this technique would obviously be much less effective than a review process, although it might be a useful supplement. The novelty of this approach in Canada would pose considerations requiring further analysis.

MANDATORY CANADIAN DIRECTORSHIPS IN ALL FOREIGN CONTROLLED FIRMS

As pointed out in Chapter Twenty, a number of countries attach some importance to having their nationals elected to the boards of directors of foreign controlled firms in their jurisdiction.

The feeling generally seems to be that this helps the foreign controlled firm to understand the economic, political and social environment of the host country and better to appreciate its cultural distinctions. It may also be intended to help integrate the foreign controlled firm into its host environment and to enable it to contribute more effectively to the local economy.

The question thus arises whether all foreign controlled firms ought to be required to elect a minimum proportion of Canadian citizens ordinarily resident in Canada to their boards of directors (say one-half). If a review process were established, legislation could be enacted directing the review agency to reject foreign investment proposals where the requirement for Canadian directors was not complied with. Other ways of achieving this objective might also exist, such as requiring by law that all foreign controlled firms incorporate federally, requiring as a condition of such incorporation that a designated proportion of the directors be Canadian citizens resident in Canada.

An alternative to this possible policy element would be to provide that the review agency could take account of the willingness of foreign firms to have Canadian citizens serve as directors as a further factor to be weighed in considering proposed investments. Provision for Canadian directors would then not be a mandatory requirement, but simply one factor to be taken into account.

The election of Canadian directors in itself is not a step of great significance. The Canadian director can simply be the figurehead for the parent company's management or he can be someone of independent strength and standing.

The possibility of achieving stronger representation might be reinforced by a requirement that Canadian elected to the boards of foreign controlled firms come from outside the company.

Although it is unlikely to be of major significance, mandatory provisions relating to Canadian directors could possibly contribute in some measure to an improvement in the performance of foreign controlled firms—particularly if this step were adopted in conjunction with other approaches that have been raised for consideration throughout this study.

SEPARATE ELECTION OF CANADIAN DIRECTORS BY CANADIAN MINORITY SHAREHOLDERS

It has been suggested above that one option for Canadian public policy could be a moderate bias in favour of Canadian minority shareholdings in foreign controlled firms. If this policy were adopted, it is important that the interests of Canadian shareholders should be adequately protected.

There are times when the interests of the Canadian subsidiary may differ from the global interests of the MNE. At such times—assuming that there are no Canadian shareholders—it is easy for the MNE to put its overall interests first.

If there are Canadian shareholders, however, it would be important to make sure that the foreign parent acts in a way that would best serve their interests. Indeed, if there are minority Canadian shareholders as a result of the policy of the federal government, the latter has even more responsibility to provide adequate protection for those shareholders.

One way to help provide this protection is by requiring that Canadian shareholders have the right separately to elect Canadian directors. In the event that the interests of the Canadian shareholders were not protected, these directors could be dismissed by the shareholders.

This kind of proposal, involving two categories of directors, is not without some precedent. Under the *Canadian and British Insurance Companies Act,* one group of directors of non-mutual insurance companies is elected by policy holders to represent their interests, while another group of directors is elected by shareholders.

While the arguments in favour of legislating minority Canadian shareholdings do not appear to be very strong, consideration should be given to providing appropriate protection for Canadian shareholders if it were decided to follow this course.

CONCLUSIONS

While it may well be impracticable, the logic of the argument in favour of the role that can be played by Canadian directors on the boards of foreign

controlled companies raises for consideration the question of whether government itself should be empowered to appoint some directors of very large multinational enterprises operating in Canada, for the specific purpose of representing the public interest.

If a review agency were established, it could be empowered to take account of the proportion of external directors who are Canadian citizens ordinarily resident in Canada. Alternatively, legislation could be passed requiring all foreign controlled firms to elect a minimum proportion of Canadian citizens ordinarily resident in Canada as external directors. In the event that revisions to the *Canada Corporations Act* are implemented in a way which would oblige directors to take greater responsibility for corporate affairs, this might have some modest, favourable impact upon the Canadian economy.

Finally, if legislation were adopted that strongly endorsed the desirabilty of foreign subsidiaries making available equity to minority Canadian shareholders, consideration should also be given to ensuring that the interests of these minority shareholders are sufficiently protected. One component of this could be to allow Canadian minority shareholders to elect directors separately from foreign shareholders.

Appendix A

NOTES ON "REPORTING SUBSIDIARIES" DATA AND THE RELATIONSHIP TO OTHER INFORMATION

At several points in this study, data are used from the Department of Industry, Trade and Commerce (IT&C) publication, "Foreign Owned Subsidiaries in Canada". This annual publication contains statistical information obtained from selected foreign owned companies in Canada. The gathering of this information followed from a letter addressed to these companies by the then Minister of Trade and Commerce, the late Honourable Robert Winters. In this letter, Mr. Winters set out twelve guiding principles of good corporate behaviour and invited subsidiaries to provide information on certain aspects of their operations and financing relating to these guidelines. They have been referred to in this study as the "reporting subsidiaries".

Following is an outline of the data obtained through this programme and their comparability with the data in certain other statistical series.

COVERAGE

The survey covers about 970 non-financial companies incorporated in Canada which are either directly or indirectly owned by one foreign parent, i.e., a foreign parent owning more than 50 per cent of the voting stock. The information on these companies is colected from about 330 respondents who file consolidated reports covering their own companies and, where appropriate, their majority owned subsidiaries. Response is voluntary, since there is no legislative authority to collect the data. The companies surveyed all have assets in excess of $5 million. The panel of companies surveyed has changed little since the survey was instituted in 1966. In a few instances, eligible companies did not report and there are also a number of large new companies that commenced operations since 1966 which are not included.

DATA

Data on operations, such as sources of income, details of expenses and dividends declared, are collected annually and cover the corporate fiscal period, which may differ from the calendar year.

Data on financing are collected on a quarterly basis and published figures represent transactions in the calendar year. All data are on a consolidated basis, thus inter-company transactions between the various companies included in the consolidation are netted out. All data are as recorded in the corporate accounts.

COMPARABILITY OF STATISTICS

(a) Statistics on overall foreign control or ownership in the economy are presented by CALURA and Statistics Canada balance of payments series. The coverage of the "reporting subsidiaries" in terms of the total assets of the companies reporting is less than that of the other two series for the following reasons:

(i) The size cut-off is much lower in both the CALURA and balance of payments series.

(ii) The Statistics Canada series designates companies as foreign controlled if the majority of voting rights is held by non-residents, regardless of whether or not that majority resides in a single foreign country and regardless of whether or not a foreign parent exists.

(iii) The balance of payments figures include certain companies where foreign control with less than fifty per cent ownership is apparent.

(iv) The CALURA series is on a non-consolidated basis, thus transactions between affiliated companies in Canada—particularly in regard to sales—are included, while in the IT&C series they are netted out.

(v) The IT&C survey covers a relatively fixed panel of companies and a number of new large companies commencing operations in recent years have *not* been added.

(vi) The IT&C survey is voluntary, while Statistics Canada collects data under statutory authority. In a few cases, eligible companies have not supplied data for the IT&C survey.

(b) Exports and Imports are recorded by Statistics Canada in Trade of Canada. In theory, data on exports for Trade of Canada purposes are f.o.b. point of consignment and are intended to exclude all charges. Imports, according to the Canadian *Customs Act,* should be valued f.o.b. point of shipment in the country of export. Statistics Canada endeavours to ensure that f.o.b. values are used, but trade statistics are not always reported in this manner.

Figures from the survey of "reporting subsidiaries" are as recorded on the books of the company. In the case of imports, these probably include Canadian duties and transportation costs within Canada, with the result that statistics from this survey would reflect higher figures for comparable imports

than would Trade of Canada. In the case of exports, the valuation procedure is not clear; they may be f.o.b. plant, delivered cost or some intermediate cost.

The IT&C figures include only direct exports and imports by the companies surveyed and do *not* include any such transactions through intermediaries not covered in the survey. Thus, total value of both imports and exports by the responding companies tend to be underestimated. This is of particular significance in the case of natural gas exports, which largely originate with foreign owned companies but are exported through a Canadian owned intermediary. Similarly, a significant amount of imports of capital equipment may be through Canadian based intermediaries.

While there are no completely comparable series available for Canadian owned companies, some indication of the importance of the volume of business carried out by respondent companies may be gauged by comparisons with other published series at the *aggregate level*. For example, in 1968 the Trade of Canada series (DBS—65-000) reports total exports of $13,624 million, while the "reporting subsidiaries" reported exports of $5,541 million, a 41 per cent share. In the same year, total imports were $12,358 million, as against $4,966 million (or 40 per cent) reported by the "reporting subsidiaries". However, as pointed out above, the values of exports and imports reported by these subsidiaries include only direct transactions and do not include transactions through intermediaries not covered in the survey. Thus, these reported values tend to be underestimated.

(c) No statistically accurate information is available on overall exports and imports industry by industry. Estimates have been made largely by arbitrary allocation of exports and imports to certain industries on the basis of products exported or imported. The usual basis for allocation of the import data is to record the commodity import in terms of the industry that might be expected to produce it in Canada. Therefore, they represent for the most part, imports of products of a type produced by the industry (or potentially so) and should not be construed as indicating those products which are imported by the industry for further processing. Since import data from the guidelines survey represent actual purchases by firms allocated to the industry, the two series are *not* comparable.

The survey of "reporting subsidiaries" classifies companies by broad industry groupings based on the principal products produced and the total exports and imports for reporting companies in each industry classification are shown. Since reporting companies may produce a variety of products, particularly where they represent a consolidation of several companies, and similar products may be produced to some extent in companies classified in other industries, comparisons between the two sets of statistics are open to considerable questions. The comparison is further affected by the variation in methods of evaluation, as noted previously.

(d) Various estimates of sales by industry are published by Statistics Canada. There are also series which may be considered proxies for sale,

such as the census of manufacturers, which contains figures on factory shipments at an establishment level. CALURA and the Business Finance Division of Statistics Canada publish sales figures on a corporate level. CALURA sales data is on an unconsolidated basis, whereas Business Finance sales figures are consolidated. The sales figures given for the "reporting subsidiaries" are largely at a consolidated level, that is they include the reporting company and its majority-owned Canadian subsidiaries. Since the higher the level of consolidation the more netting out of intra-corporate sales, the subsidiaries' sales would be recorded at a lower level than the same transactions recorded in other series. The comparison of industry sales is further affected by classification problems involved in allocating a multi-company enterprise to a specific industry.

According to CALURA, total sales of non-financial corporations for 1968 amounted to $1.04 billion, while those of the "reporting subsidiaries" responding to the survey were $22,718 million (22 per cent). Conceptual differences are present in this comparison in that the former series has a much lower "cut-off" and the information is collected from the companies concerned on a non-consolidated basis. The latter difference has the effect of understating the coverage of the subsidiaries in terms of CALURA coverage.

In comparing the reported total sales of the respondent companies with those of "50 per cent or more foreign owned", as published by CALURA, the same two above-mentioned factors are present, together with the further conceptual difference of "50 per cent or more foreign owned", *vis-à-vis* "more than 50 per cent owned by one foreign parent". However, such a comparison shows the respondents accounted for some 55 per cent of the sales quoted in the "50 per cent or more foreign owned" category of the CALURA report for 1968.

When the data are broken down into industry group level, the respondents' coverage of the category differs widely between groups, ranging from very high in transportation equipment down to very low in wholesale trade and mining and primary metals. In the latter industry, low coverage is to some extent due to the effects of conceptual differences between the survey and CALURA. The guidelines survey excludes companies which, although more than fifty per cent foreign owned, have no single parent owning more than fifty per cent of the voting stock, thus excluding widely-held foreign companies and also joint ventures in which no single company owns a majority of the stock.

Table I (p. 523) shows coverage by industry group, with the CALURA date re-arranged to match the survey's eleven industry groupings.

It should be borne in mind that if the data on "reporting subsidiaries" were collected on a non-consolidated basis, coverage in terms of sales by industry groupings would no doubt be different. Some paper companies (presently classified to pulp and paper) have wholesale subsidiaries. This tends to underestimate the coverage in wholesale trade but, because of the netting out of inter-company sales, does not overstate the coverage of the

pulp and paper group to any significant degree. In other cases, for example, oil companies with subsidiaries in the chemicals industry, whose total sales are presently included in the gas and oil group, overstate the coverage of the latter and understate the coverage of the chemicals group.

TABLE I

PROPORTION OF SALES OF COMPANIES 50 PER CENT AND OVER FOREIGN OWNED (CALURA) ACCOUNTED FOR BY THE "REPORTING SUBSIDIARIES" (1968)

Industry Group	Per Cent
Mining and Primary Metals	26
Gas and Oil	86
Machinery and Metal Fabricating	52
Transportation Equipment	93
Electrical	76
Chemical	67
Food and Beverage	81
Pulp and Paper	71
Other Manufacturing	49
Wholesale	17
Other Non-Manufacturing	34
Total	55

Regardless of the inconsistencies present between the two series, it is considered that, in general, the figures give a reasonably good measure of the survey respondents' share of the foreign owned non-financial sector.